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An opportunity exists in American politics. The White House and the Democrats should grab it: leader

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Politics this week

Feb 22nd 2007
From The Economist print edition

Reuters

Italy's prime minister, Romano Prodi, tendered his resignation after only nine months in office. He did so after a mutiny in his sprawling coalition led to the defeat in the Senate of government proposals to keep troops in Afghanistan. See article

Tony Blair said the number of British troops in **Iraq** would fall from around 7,100 at present to around 5,500 in the next few months, but that a British military presence would remain there at least into 2008, "for as long as we are wanted". Denmark said it would withdraw all its 470-odd troops by August. See article

The commander of **Russia's** strategic forces warned Poland and the Czech Republic that they could be targeted with nuclear weapons if they agree to host American anti-missile defence bases. America says the radar and rockets are designed to counteract Iranian missiles, not Russian ones. See article

Poland's governing Law and Justice party is suing the country's former president, Lech Walesa, for defamation. Mr Walesa called the current incumbent, Lech Kaczynski, a "blockhead" in a row over a report on alleged criminal activity and Russian influence in the country's now disbanded military-intelligence service. See article

Ségolène Royal, the Socialist candidate for the **French presidency**, rejigged her campaign, promising more help for the low-paid and shuffling her advisers. Polling had shown her lagging Nicolas Sarkozy, her centre-right opponent, by ten points.

European Union environment ministers agreed in principle to cut **greenhouse-gas emissions** by 20% from 1990 levels by 2020. The plan, and the list of countries which will take most of the burden, must be agreed to by heads of state.

Judicial review

An appeals court in America ruled that suspected terrorists held at **Guantánamo Bay** do not have the right to challenge their detention in a federal court. The decision upholds legislation passed by Congress last autumn that was written to clarify the law, but the issue may end up yet again in the Supreme Court.

The Democrats failed to break a Republican filibuster in the **Senate** that would have allowed a vote on a resolution criticising George Bush's policy in Iraq. Seven Republicans, including John Warner, the former chairman of the Armed Services Committee, joined the Democrats. The House of Representatives passed a similar resolution last week.

John McCain went to Iowa and Florida, where he courted social conservatives by proclaiming his strong support for anti-abortion legislation. The Arizona senator is expected to announce his bid for the White House next month.

An attack on peace

AFP

Two bombs exploded on the Friendship Express, a train travelling from Delhi in **India** to Lahore in **Pakistan**. In the ensuing inferno, at least 68 people, mostly

Pakistanis, died. Indian experts suspected Islamic militants with bases in Pakistan, but the two countries said the atrocity would not affect their peace process. Their foreign ministers went ahead with planned talks in Delhi, where the two countries signed an agreement on reducing the risk of accidental nuclear conflict. See article

A United Nations special rapporteur, Philip Alston, accused the army in the **Philippines** of being in a state of denial about a spate of extra-judicial killings "convincingly attributed" to the security forces.

Muhammad Yunus, founder of Grameen, a big microfinance institution, entered into **Bangladeshi politics** with the formation of a new party. Separately, the military-backed government said it would take eight to ten months to prepare the voter-identity cards needed for an election. See article

Too close for comfort

Colombia's foreign minister, María Consuelo Araújo, resigned after her brother, a senator, was arrested over allegations that he received cash from right-wing paramilitaries. The escalating scandal over links between the paramilitaries and pro-government politicians has brought criticism of the government of Álvaro Uribe from the United States Congress, which provides Colombia with around $600m a year in aid. See article

Jean Charest, the Liberal premier of **Quebec**, called a provincial election for March 26th. Opinion polls give the Liberals a five-point lead over the separatist Parti Québécois. See article

The crackdown on drug-traffickers by **Mexico's** president, Felipe Calderón, continued as 3,000 troops were sent to two states bordering the United States and an assistant state prosecutor was arrested over alleged links with a drug gang. Meanwhile, gunmen in the border city of Nuevo Laredo shot and wounded a federal congressman.

According to his niece, **Fidel Castro** is in "stupendous" condition and will be "very active" again as he recovers from stomach surgery that led him to hand over his powers as Cuba's president to his brother, Raúl.

Blowing another raspberry

Iran ignored a UN deadline to suspend its uranium-enrichment programme by February 21st or face wider sanctions. After the International Atomic Energy Agency, the UN's nuclear watchdog, meets early next month, the UN Security Council will have to decide on further steps to try to squeeze Iran into compliance. See article

AFP

The American secretary of state, Condoleezza Rice, met the **Israeli** prime minister, Ehud Olmert, and the Palestinian president, Mahmoud Abbas, together in Jerusalem, but appeared to have made scant progress towards restarting a peace process in earnest. See article

Rival **Palestinian** parties, meanwhile, continued to argue over the interpretation of their agreement signed earlier this month in Mecca, where they were supposed to have settled the terms of a national unity government.

The UN Security Council authorised the African Union to send peacekeepers for six months to **Somalia**, where Islamists were routed last month by troops from Ethiopia. It was unclear how soon the troops would arrive. Meanwhile, mortars, presumably launched by Islamist remnants, killed 16 people in the capital, Mogadishu.

Speaking on his 83rd birthday, **Zimbabwe's** president, Robert Mugabe, seemed to confirm rumours of mounting intrigue within his ruling circle by accusing unnamed senior colleagues of plotting to oust him from office.

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Business this week

Feb 22nd 2007
From The Economist print edition

In a closely watched decision America's Supreme Court overturned **punitive damages** of $79.5m against Philip Morris that were handed down by a jury in 1999. The case centred on an Oregon man who had smoked for 42 years and died of lung cancer. The Supreme Court ruled that the jury's award to his widow had overstepped the mark by punishing the cigarette-maker for harm done to others, but it failed to set any limits on future punitive-damage awards and sent the case back to Oregon's state Supreme Court for a new hearing. See article

The European Commission slapped its biggest-ever antitrust fine, €992m ($1.3 billion), on five **lift manufacturers** it accused of operating a cartel. Germany's ThyssenKrupp and America's Otis were among the companies the commission said had “artificially bloated” the construction and maintenance costs of buildings in European countries.

Transmission problems

After years of intense rivalry, **Sirius** and **XM** announced their intention to merge. Once considered the new kids on the block, the satellite-radio networks have been struggling to respond to competition from recent advances in broadcasting, such as through the internet. Their merger is far from certain; America's communications and antitrust regulators promised that the $4.6 billion deal will be heavily scrutinised. See article

Google encroached further into Microsoft's territory by offering businesses a new set of web-based word-processing and spreadsheet services. The internet company released a similar package to consumers last year.

Another effort is under way to combine **Warner Music** and **EMI**. Warner confirmed it had approached EMI after obtaining support from IMPALA, the trade group for independent music-labels in Europe. Last year IMPALA complained to the EU that consolidation among big music companies would hurt competition.

The board of **Portugal Telecom** rejected an improved €11.8 billion ($15.5 billion) bid from **Sonae**, a Portuguese conglomerate, and bolstered its defences by announcing a €6.2 billion shareholder-remuneration package. The saga of what would be Portugal's biggest takeover has been rumbling on for a year.

Conquistadors

Banco Bilbao Vizcaya Argentaria made its biggest acquisition outside Spain when it agreed to buy **Compass Bancshares** in a $9.6 billion transaction. BBVA has been steadily increasing its business in the southern and south-western United States, on account of the region's growing Hispanic population. Compass, based in Birmingham, Alabama, operates more than 415 banks from Arizona to Florida, including 164 in Texas.

Sberbank, Russia's largest savings bank, looks likely to have raised $8.8 billion from its share offering, the country's second-biggest following last year's issue by Rosneft, an oil firm. Sberbank's sale raised a bit less than had been forecast by analysts. Some investors had grumbled that the prospectus was only available in Russian and that the bank (unlike Rosneft) won't be selling shares on foreign exchanges.

HSBC replaced the head of its North American unit, which has been reeling from losses in the **subprime mortgage** market. Meanwhile, the share price of NovaStar Financial plunged by 40% as it revealed losses in the subprime market.

EADS, the parent company of **Airbus**, delayed launching a long-awaited restructuring plan because of “cross-national” difficulties about job costs and workloads related to the A350XWB. Last year Airbus was beset by production delays surrounding its A380 super-jumbo; both projects are crucial to Airbus's future competition with Boeing.

A plan to merge India's two biggest state-owned airlines, **Air India** and **Indian Airlines**, came closer to fruition after it was approved by the country's aviation minister. The proposal will create a national carrier that could compete as one of the world's top 30 airlines. The minister also said that a promised merger announced last month between two private domestic carriers, **Jet Airways** and **Air Sahara**, would be permitted.

Sweden's **Volvo** agreed to buy the 81% of Japan's **Nissan Diesel** it does not own in a SKr7.5 billion ($1.1 billion) deal. The combined company will overtake DaimlerChrysler to become the world's biggest maker of heavy lorries.

Feeling less deflated

Japan's Topix stockmarket index (a broader measure than the Nikkei) reached its highest level since November 1991, helped by share prices of big banks which rose in response to the **Bank of Japan's** decision to raise interest rates by one-quarter of a percentage point, to 0.5%.

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American politics

Saving the Bush presidency

Feb 22nd 2007
From The Economist print edition

Kevin Kallaugher

An opportunity exists in American politics. The White House and the Democrats should grab it

Get article background

HISTORY can be kinder to presidents than journalists and voters are. Like Truman, Johnson and Nixon before him, George Bush has seen his approval ratings wither under the burden of an unpopular war. But all three of those presidents look better now than they did when they were in power. Is it possible that the same, one day, will be said of Mr Bush? The verdict of history will depend not just on the first six years of his presidency, but on the last two as well. And there is some room for hope that in the 100 weeks left to him he can push himself up the rankings, especially in domestic policy.

That is not to deny that foreign affairs will be central to Mr Bush's reputation. His name will be forever associated with bloody bungling in Iraq, the blatant injustice of Guantánamo Bay, the corrosive stalemate in the Middle East and, alas, much more. Not all these blunders are wholly Mr Bush's fault, but he should strive to rectify them, whether it be by giving the “surge” of troops in Baghdad the best possible chance of success, seeing through his half-finished policy in Afghanistan (see article), or being more creative in the search for a solution to the Israeli-Palestinian dispute.

Too easily obscured by these monumental challenges are other pressing possibilities closer to home—opportunities American politicians should not ignore. Even if Mr Bush's main legacy lies in Mesopotamia, he should not forget about Maine and Minnesota. And neither should the Democrats.

A prize of sorts

For there is suddenly a lot at stake in American domestic politics (see article). His whipping in the mid-term elections seems to have had an effect on Mr Bush: his most senior officials are quietly exploring the possibility of deals with his opponents. Reforms may be hammered out in education and immigration and (at a stretch) the environment and the Social Security pension system. Even in health care, lots of good new ideas are flying about; and the chance of Mr Bush keeping fast-track authority for trade deals has not entirely gone.

The Democrats' calculations have also changed. Many of the Bush-loathing party faithful would rather delay progress of any sort until a Democratic president is elected in 2008. But the party's more

pragmatic leaders, such as Senator Hillary Clinton and Nancy Pelosi, the new speaker of the House (see article), know that they have to win the election first—and that moderate voters may not take kindly to them if they do nothing. That means dealing with Mr Bush, who is still a veto-wielding president. Several causes dear to Democratic hearts, such as a cap-and-trade system for carbon emissions, could be blocked by Mr Bush unless he has an incentive not to do so.

Education is the area where progress is likely soonest. One of Mr Bush's domestic successes, the No Child Left Behind Act, requires schools to test pupils more and publish the results. It has helped improve basic literacy and numeracy a bit, but would work better if it were more rigorous. Republicans want to tighten up the testing part, but not to spend much more money. The Democrats, enslaved to the teachers' unions, want the precise opposite. A swift compromise, involving better tests and a bit more money, will not solve the problem of America's schools, but it is considerably better than nothing.

A bigger, though much harder, prize will be immigration. Mr Bush's plans, which involve tighter border security, a guest-worker programme and a path to citizenship for the 12m or so illegal immigrants already in America is sensible and humane. The Democrats mostly agree with him: the plan failed last year because of opposition from House Republicans, who have now lost their majority. A concerted push could produce a breakthrough—though Mr Bush will have to be brave enough to split the Republican Party to get it.

Or there is the environment. Mr Bush favoured capping carbon emissions until the voices of industry prevailed. But change is in the air. The president now accepts that humans have helped make the planet hotter. All the presidential front-runners, Republican and Democratic, favour some form of carbon-capping. Assuming a climate-change bill emerges in Congress, Mr Bush will face a stark choice: veto it, watch the Democrats claim the higher ground, and, almost certainly, see a far tougher bill go through after 2008; or help draft a milder version now, improve his party's reputation on green issues and just possibly lure India and China into a global arrangement. How that would change the Toxic Texan's legacy.

What about the huge entitlement programmes which, unchecked, will bankrupt the federal government? On Medicare, the health programme for the elderly, serious progress looks impossible: the parties are too far apart and the problem too intractable. But reforming the tax treatment of health insurance and extending coverage to more children looks plausible. As for Social Security, the “third rail” of America politics, everyone knows that a compromise would be based on some combination of benefit cuts (as Mr Bush prefers) and higher revenues (the Democrats' solution), with perhaps the new revenues going into personal retirement accounts through which people could also be forced to save more. Neither side is budging an inch; but the involvement of the pragmatic Hank Paulson, the banker turned treasury secretary, is a good sign.

Judge them in 2008

It would be foolish to hope for too much: the ill will is great, compromises are hard to fashion and time is short (the next presidential contest is soon upon us). But it would be foolish too to demand too little, for two reasons.

First, divided government has often produced fruitful compromises: think of Ronald Reagan's 1986 tax reform or Bill Clinton's welfare reforms of ten years later. And second, compromise in many of the issues now under discussion is not just feasible, but the right thing to do. If Mr Bush leaves little of substance behind at home in areas as important as immigration and pensions, he deserves all the rough handling history can give him. As for the congressional Democrats, if they stand in the way of progress, they will deserve a mauling in 2008 just as surely as the Republicans did in 2006.

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Germany's cars

Losing their vrroooom?

Feb 22nd 2007
From The Economist print edition

Smaller cars and greener consumers threaten Europe's most impressive industrial machine

TOYOTA may be hustling to overtake General Motors as the world's largest carmaker, but for the past 20 years the smartest part of the road has belonged to a remarkable German quartet of engineering masters. Mercedes, BMW, Audi and Porsche have thrived, as the world's richest car markets have come to desire the speed and comfort that the autobahn-driving Germans have long demanded. By creating vehicles for the one-in-three Germans who owns a top-end car, German carmakers have won over drivers everywhere, including the one-in-ten Americans with a craving for wheeled luxury.

Superb engineering and crafty marketing have not just helped make “Mercs” and “Beamers” into status symbols from Shanghai to San Diego; they have also given Germany's carmakers an unusual status in the battered world of European industry. The car business accounts for one in seven manufacturing jobs in Germany. Moreover, they are famously good jobs—proof to many Europeans that world-beating corporate performance is compatible with strong unions, works councils, consensus management and the rest of it.

Yet angst has begun to creep into this industrial Valhalla (see article). Volkswagen, the maker of Audis and the closest Germany has to a full-range carmaker, looks destined to fall under the corporate control of Porsche. A storm has engulfed DaimlerChrysler, Mercedes's parent, after Chrysler's big, expensive minivans and Jeeps lost their appeal for Americans newly bent on economical Toyota Camrys and Honda Accords: Daimler is now talking about selling Chrysler. Angela Merkel, Germany's chancellor, is sufficiently worried about her industrial champions to lobby energetically against European Union limits on automotive carbon emissions.

Optimists point out that the car industry is a notoriously volatile business (one moment Italy's Fiat is looking for a rescuer; a couple of successful launches later it is the toast of Europe). And thanks to demand in the emerging world, the global car market has seldom looked more enticing: more vehicles will be produced in the next 20 years than during the whole of the past century. All the same, the suspicion is growing that Germany's carmakers are caught the wrong side of two huge coming shifts in demand—towards fuel-efficient “sensible motoring”, especially in the developed world; and towards “cheap and cheerful” cars, especially in Asia.

Logan's run

Begin with the cheap and cheerful side of it. Some 180 new factories, each producing 300,000 vehicles,

are set to double global annual production, to 110m units a year. Many of these plants have already been built (in China capacity is temporarily outstripping supply) and it is already clear that their main focus will be not premium saloons, but basic rides selling for less than €10,000 ($13,000). Hyundai of South Korea plans an ultra-low-cost car for South-East Asia and Fiat is hooking up with India's Tata. Several Indian scooter-makers—and one Italian one—are going down the same path. Tata even plans to introduce the "One Lakh Car", an ambitious plan to make and sell a vehicle costing less than 100,000 rupees ($2,300).

And this basic part of the car market is not just confined to the emerging world. As markets polarise between luxury and budget, the beacon is the outstanding success of Renault, which makes its basic Logan car in Romania and sells it in 42 countries, including parts of western Europe. Ford is teaming up with Fiat in Poland to produce a new entry-level car for Europe, while GM is pinning Chevrolet badges on low-cost Daewoo cars made in South Korea, also to be sold in Europe.

This poses problems for all sorts of carmakers. Even mighty Toyota recognises it needs a step-change in its manufacturing if it is to come up with a car for the masses in emerging markets. But small, cheap cars are hardly a natural market for the titanic Teutons. Their small-car subsidiaries, such as BMW's Mini and Daimler's Smart car, make fancy cars, not cheap ones. For its part, VW has lost its small-car edge in China and makes most of its money from posh Audi. The German carmakers' costs are too high and their brands too valuable to sully with low-budget overtones. And both the Chrysler takeover and BMW's ill-starred purchase of Rover show how hard it is for them to buy their way into the general market.

Stop at green

Why not abandon the volume market, then, and focus on the premium market, which is due to grow as well? Because carmakers look to spread the formidable costs of research and development over as many vehicles as possible. Fancy new electronic injection can make fast cars more powerful still and also be used to improve fuel economy. And who is to say that the new low-cost producers won't push upmarket—as Japan once did? China's SAIC has a promising new saloon for its domestic market (see article) and Zhongxing said this week it would sell low-cost SUVs into America within a year.

Besides, the premium part of the market may be changing towards "sensible motoring". As the traditional German virtue of reliability has gradually been copied, so the country's cars have increasingly been sold by appealing to the "passion" of petrol-heads—witness BMW's ultimate driving machine. But there is nothing ultimate about gridlock, traffic-management systems and congestion charges. And now there is greenery to consider—whether it be emissions standards or a social shift that makes people guilty about big cars. The Germans have not been to the fore in this: only six German-made cars currently meet the EU target Mrs Merkel is fighting, compared with 34 made by their competitors.

It would be foolish to bet against Germany's carmakers with their formidable history of engineering and design. After all, they invented the automobile, and are still impressively successful. Doubtless their fabled design teams will create more efficient engines and lighter cars; but will those cars be made in Germany? Only Volkswagen so far has taken advantage of the cheaper labour in central Europe. After motoring with the wind at its back, Europe's most impressive industrial machine faces a less smooth ride.

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The world economy

Switching engines

Feb 22nd 2007
From The Economist print edition

Global economic growth has become less dependent on American spending

David Simonds

IN RECENT years the American economic locomotive has pulled along the rest of the world, while frugal firms and households elsewhere have preferred to save not spend. So, at least, goes the popular wisdom. Signs that America's boom may be fading have therefore caused concern around the globe. Typically in the past, when America's economy has weakened, the rest of the world soon flagged. But this time—so far, anyway—looks different. The rest of the globe has speeded up even as the American engine has lost steam.

The figures are striking. The annual rate of growth of America's real domestic demand dropped from 4.4% in 2004 to only 1.9% in the second half of last year. The main culprit was the sickly housing market: although consumer spending has held up better than expected, the construction of homes has collapsed. So is the rest of the world also wobbling? On the contrary, many other economies have put on a spurt. Japan's GDP grew by 4.8% at an annual rate in the fourth quarter, mainly thanks to stronger domestic demand. Granted, Japan's GDP figures are notoriously erratic, and this jump follows a poor third quarter. Even so, it was much stronger than expected and gave the Bank of Japan the confidence at last to raise interest rates by another quarter of a percentage point (see article). Equally surprising was the euro area's annualised growth of 3.6%. GDP per person is now growing faster in the euro area than it is in America. Domestic demand is also booming in emerging economies in Asia, the Middle East and Russia.

All of this is helping America to sell more abroad. In the year to the fourth quarter, its merchandise exports rose by 15% in value, their fastest pace since 1988. By contrast, import growth slowed to only 4%. In 2006 as a whole, America's sales to China rose by a third, almost twice as fast as its (admittedly larger) imports from that country. Last year was the first since 1997 in which America's exports rose faster than its imports. America's trade deficit is still huge, but it began to narrow at the end of last year, amounting to 5.3% of GDP in the three months to December, down from 6.1% in the same period of 2005. Indeed, by the fourth quarter net trade with foreigners added to America's GDP growth rather than pulling it down.

A reason to be cheerful

The idea that the world economy was being pushed along in an American supermarket trolley was always

an exaggeration: the $500 billion increase in America's current-account deficit over the past five years may seem huge, but it is equivalent to an annual increase of only 0.2% of global GDP. The difference now is that the rest of the world is doing more of the carrying.

Of course, countries like Japan, Germany and China still run large trade surpluses, which means they are producing more than they buy. But it is the change in a country's surplus, not its absolute size, which adds to its growth. For example, China's current-account surplus hit a new record of around 8% of GDP last year. But according to Goldman Sachs, the increase in China's net exports accounted for 2.2 percentage points of the country's 11% GDP growth last year, down from 2.7 points in 2005. The investment bank thinks this contribution will shrink to 1.6 points this year. Most of China's growth comes not from exports but from domestic demand—and consumption is stronger than the official figures suggest (see article).

These are early days, so don't get carried away. The real test of the rest of the world's stamina will come over the next year, as the negative wealth effects of falling home prices start to weigh on American consumer spending. But also take some confidence from the evidence thus far: the world economy may be able to cope without American shoppers.

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India and Pakistan

Staying on track

Feb 22nd 2007
From The Economist print edition

United in anger at another atrocity, India and Pakistan should speed up their peace process

AFP

THEY are the most terrible of punctuation marks in an otherwise optimistic story. Every few months a bombing somewhere in India claims dozens of ordinary lives, killing random unfortunates going about their daily business. The attacks are usually blamed on militant groups fighting Indian rule in part of divided Kashmir, and on elements of the Pakistani intelligence services that allegedly help them. Each murderous onslaught sets back the painstaking progress India and Pakistan are making in ending the rancorous, bloody feud that has scarred the 60 years since independence and partition.

So far, however, none has succeeded in scuppering the three-year-old peace process. It survived even last July's serial bombing of Mumbai's commuter trains, which killed nearly 200 people, and which the Indian police explicitly blamed on Pakistan. The latest atrocity—the bombing of a train taking people from Delhi to Lahore in Pakistan, killing at least 68—has similarly failed (see article). Both countries condemned the outrage; both insisted the peace process was intact; and, lending weight to this claim, Pakistan's foreign minister, Khurshid Kasuri, proceeded this week with a visit to Delhi.

Although both governments deserve applause for the maturity of their reactions, both should be urged to go further. They should use their shared outrage not just as an excuse to carry on with a peace process that edges forward inch by inch, but to make a real effort to bring it to a successful conclusion.

This attack was unusual in that many of the victims were Pakistanis. Some of their countrymen suspected an act of terrorist revenge from extremists of India's Hindu-nationalist right. Indian fingers, however, plausibly pointed at the usual jihadist suspects. These fanatics have political, religious and even financial interests in keeping India and Pakistan at odds, and Kashmir in a state of vicious low-level insurgency.

It would be easier to identify the culprits if India and Pakistan were to share intelligence more fully. To salvage the peace process from the wreckage of the Mumbai bombings a “joint mechanism” was promised to allow just such co-operation. But it is difficult to change the habits of a lifetime and each country's spies have spent theirs guarding and conspiring against the other's. Now, however, is the time to try.

More than that, it is the time to move from interminable process to possible outcome. India is the status

quo power in its core dispute with Pakistan, over Kashmir. It has no interest in enforcing its own claim to Pakistani-held Kashmir. Rather, India's prime minister, Manmohan Singh, says a precondition to a settlement is that there should be no “redrawing of boundaries”. So, for many in the Indian establishment, the process is the point—keep it going long enough and war will seem impossible and the present dispensation immutable.

Yet, as every outrage proves, the present dispensation is intolerable. It also hampers India as it strives to convert its fast-growing economy and huge international prestige into the global power it deserves. Moreover, in leaks from “back-channel” talks, and in the undiplomatic candour with which Pakistan's president, General Pervez Musharraf, on occasion publicly weighs the options, the outlines of a settlement acceptable to both sides are emerging. It would involve a “softer” border, some co-operative institutions, greater autonomy for both bits of Kashmir and a gradual withdrawal of Indian soldiers from Kashmir as violence decreases.

Both sides, now

Sadly, every bomb attack pushes such a settlement, and even solutions to pettier bilateral squabbles, further into the future. No one, after all, wants to be seen to be buckling in the face of terrorist pressure. This is wrongheaded. Such a settlement might not bring an immediate and perpetual end to the bombings, but it would dispel the murk of ambiguity where terrorism thrives and ordinary citizens lose their lives pointlessly. It would make clear, as did this week's horror, that the bombers are the enemies of Pakistan as well as of India.

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Financial centres

Offshore and beyond the pale

Feb 22nd 2007
From The Economist print edition

Tax havens are an unavoidable part of globalisation and, ultimately, a healthy one

Gary Neil

FOR politicians, tackling budget deficits means making difficult and unpopular choices—unless, that is, they can find a scapegoat. On February 17th three American senators, including Barack Obama, a Democratic presidential candidate, introduced the Stop Tax Haven Abuse Act. The senators claim that tax havens—small jurisdictions that draw offshore money through business-friendly rules and low (or no) taxes on non-resident business—drain the Treasury of $100 billion a year, over a third of America's annual budget deficit. “This is a basic issue of fairness and integrity,” said Mr Obama.

Island Revenue

The same thought has struck politicians in other Western countries, particularly ones with large budget shortfalls. They lambast tax havens for sucking in the money of foreigners and multinational companies. Robbed of revenues, more respectable governments are “forced” to tax less mobile factors, like labour. This hurts the poor and threatens sovereignty.

Tax leakage is real. Some of it is clearly illegal—such as when a businessman salts away money abroad to evade taxes—and deserves to be punished. But most leakage is actually tax avoidance—minimising your tax bill, often by finding loopholes in the thicket of tax rules in big countries. Multinationals routinely shrink their tax bills by attributing profits to subsidiaries in tax havens—and who can blame them?

Singling out tax havens as the culprits behind tax flight is out of date, for two reasons. First, the days when a Caribbean island or a European principality could flourish purely as a hiding place for illegal cash are fast disappearing, as our special report in this issue explains. Thanks to international campaigns against money laundering and illegal tax evasion, today's successful tax havens thrive not because of crookery, but because they are well run and well regulated.

Second, tax competition nowadays is mostly about big countries competing with each other. With capital mobile and economies increasingly interlinked, money will continue to move to places where costs, including taxes, are low. Preventing this means either harmonising taxes (a genuine threat to sovereignty) or clamping down on nations, even big ones, that have the gall to streamline their tax systems. This would be ruinous to trade and, in the end, futile: new low-tax centres would emerge as soon as old ones were squashed.

In fact, a bit of tax competition is healthy. Like all monopolies, governments tend to become bloated. Competition from countries with simpler tax systems encourages high-spending governments to change. But it does not force them to do so: in the richest countries the tax take as a share of GDP has increased in the past three decades even as tax rates have fallen and offshore finance centres have multiplied.

Whatever Mr Obama might think, governments are not powerless. They can lower rates (so that taxpayers do not have such cause to cheat) and simplify codes (so that gaming them is harder). The World Bank points out that Russia slashed taxes by a third in 2001 and simplified its tax code: compliance increased and tax revenues, admittedly helped by energy prices, rose at an average rate of 14% in the next three years.

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About sponsorship

On India's economy, health spending, Peru, religious freedom, executive pay, Barack Obama

Feb 22nd 2007
From The Economist print edition

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Is India still shining?

SIR – Your briefing on India's overheating economy raised several relevant matters, but also contained some careless omissions ("India on fire", February 3rd). For example, you didn't mention that the recent interest-rate rise on January 31st followed both an unexpected increase in the cash reserve ratio by the central bank and cuts to import duty on several items by the government in order to check inflation. You also gave the incorrect impression that the interest-rate rise was "timid", because it increased the overnight lending rate and not the overnight borrowing rate. In the current money market conditions, where banks have to approach the central bank for borrowing, the overnight lending rate is in fact the key operational policy rate.

Other items you overlooked were the improvement in foreign direct investment (this year net FDI is likely to exceed portfolio investment for the first time), the well-diversified nature of the equity market, the string of record profits in the corporate sector, and the high marks Indian companies get for their transparency and corporate governance compared with many other emerging markets.

Rajeev Malik
Senior economist
JP Morgan Chase Bank
Singapore

SIR – A hard landing for the Indian economy is quite apparent from the super-charged property market. Property prices are rising at an awesome rate of 10-30% each quarter and are beyond the reach of most prospective buyers. In the suburbs of Mumbai one can see block after block of empty buildings amid the new construction projects, yet private banks enthusiastically lend money on the premise that the economy will continue to grow at a high rate.

With the derivatives market in a nascent stage there is little that they can do to offload these risks from their balance sheets. The government's recent diktat to the banks not to raise interest rates on home loans enables the speculators and builders to continue with their party and thus keep the overall growth rate artificially high. If the real-estate market implodes the banking system may also go down in its wake.

Sanjay Bhatia
Mumbai

Health priorities

SIR – It would be wonderful if Ghana's per-person health budget were "$31 per day" ("New vaccines for old killers", February 17th). However, the World Health Organisation calculates that it is $31 per year, compared with $2,047 in Britain and $2,548 in the United States. This painful disparity in health spending is aggravated by the fact that the vast majority of medical research is devoted to the health problems of rich countries. Melinda and I believe that innovative financing initiatives, such as the Advanced Market Commitment for pneumococcal vaccine, can harness the expertise of private industry and help close this research gap so that one day, those born in the developing world will have the same chance for good health as those born in America and Britain.

Bill Gates
Co-chair
Bill & Melinda Gates Foundation
Seattle

Statistically speaking

SIR – I was surprised to find that Peru has been excluded from the list of countries covered in your economic and financial indicators (January 6th). The decision is untimely: Peru's economy is growing rapidly and has been upgraded by the big risk-analysis institutions. Last year its stockmarket rose by some 200% and one of our leading mining companies was successfully launched on the London Stock Exchange.

Although I understand that the change to the layout of your indicators pages is essentially an editing initiative, you will undoubtedly appreciate that it is unwise to exclude Peru from your statistical reporting at a time when the country is attracting a lot of attention from international businessmen.

Ricardo Luna
Ambassador to Peru
London

Faith-based providers

SIR – The state should not, as you posit, force religious agencies to act against their conscience when providing social services ("Render unto Caesar", January 27th). I do not require the rest of the world to live by my moral standards. And even though I may think it would be a better place if everyone did exactly that, I recognise the need to convince by argument, not legislation. In forcing Catholic adoption agencies in Britain to put gay couples on their books the potential gain to equality seems rather slight given the actual assault on religious freedom. It is one thing to legislate to prohibit religious excesses, such as burning opponents at the stake, but quite another to compel religious groups to do what they feel is wrong. If euthanasia is legalised, will you then think it imperative to forbid such groups from offering hospice care unless they also assist in making premature death available?

Osmond Plummer
President
Crossroads Church
Ferney-Voltaire, France

Turning a profit

SIR – Your special report on executive pay argued, correctly, that the majority of shareholders get value for the money they hand over (January 20th). But when deciding value, one should ask if higher pay will produce an equivalent return. Contrary to the idea that high pay is needed "to recruit good managers and get them to take difficult decisions" some of the greatest business leaders, such as Marvin Bower of McKinsey, have shown a willingness to forgo what they could have squeezed from their shareholders in order to make their companies stronger.

Peter Noteboom
Cambridge, Cambridgeshire

SIR – It is true that most people readily criticise high pay for executives, whether or not it is earned. Yet nobody questions overpaid athletes, musicians or actors, who we seem to think are too precious to get a real job. For instance, Tiger Woods is on his way to becoming a billionaire just for hitting golf balls every day. Is his work that much more difficult than running a multi-billion-dollar global company?

Oliver Reif
Tacoma, Washington

Shades of blackness

SIR – I agree that in order to maintain their growing political clout, black Americans must stop thinking in terms of race (Lexington, February 3rd). But this may be hard to accomplish when it comes to Barack

Obama. A black author, Debra Dickerson, recently fumed that “Obama isn't black”. While a black columnist, Stanley Crouch, has declared that, “When black Americans refer to Obama as ‘one of us', I do not know what they are talking about.”

I find it preposterous that my fellow black Americans harbour misgivings about supporting Mr Obama. Such feelings underline the nuances and complexity of America's race relations, but we are asking the wrong question in “Is Obama black enough?” The real question is not about the colour of his skin, but rather the thinness of ours.

Malou Innocent
Washington, DC

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About sponsorship

Afghanistan's war

A double spring offensive

Feb 22nd 2007 | KABUL, KAJAKI AND KANDAHAR
From The Economist print edition

Ministry of Defence

After a dreadful year in Afghanistan, a newly confident NATO is preparing itself to take on the Taliban. Success will be difficult, but not impossible

Get article background

THE Kajaki dam, with its turquoise lake lost in the rocky wilderness of southern Afghanistan, is an unusually scenic setting for battle. On the heights above, British marines at the sharp end of NATO's war against the Taliban routinely come under fire from guns and rockets. But over the past two months the Taliban have been pushed back by NATO's firepower and their continued pot-shots are, for the moment, little more than harassment.

On a recent evening a single round from a Soviet-era anti-aircraft gun, fired from six kilometres (just under four miles) away, provoked a full pyrotechnic response: dozens of mortar rounds, bursts of red tracers from a 50-calibre machinegun, illumination flares, the flaming rush of a Javelin missile and the juddering explosion of a 1,000kg guided bomb dropped from a Harrier jet. An American B-1B bomber was on hand to follow up; an Apache helicopter provided surveillance.

After the show was over, the Royal Marines reported two Taliban sentries killed and others fleeing. An expensive operation for the end result, perhaps. When the fighting is on the ground, it is more treacherous and does claim marine lives. The wadis and labyrinthine Afghan compounds, with their metre-thick walls, provide excellent cover. The Taliban are good shots, conceal themselves well and evacuate their casualties efficiently.

Even so, the Royal Marines at Kajaki are now fighting on highly favourable tactical terms. The flight of Afghans from surrounding villages reduces the risk of killing civilians. The marines choose when and where to attack. They hold the high ground, they have high-powered observation equipment and mastery of the air. “We see them three kilometres away. They cannot see us 200 metres away,” says one officer. “It's unfair sometimes.”

The problem is the wider strategy. The Taliban have a seemingly inexhaustible supply of recruits, enjoy sanctuary in Pakistan and almost certainly have greater staying power than the foreign troops. The marines do not have the numbers to hold more than the immediate area around the Kajaki dam. From their dominant hilltops—called Athens, Normandy and Sparrow Hawk—all they survey with their high-tech gadgetry is Taliban country. So the marines now perform a strange dance: they raid Taliban

hideouts (as in the picture above), they withdraw—and then they watch the enemy return.

Just for now, this is good enough for NATO. After a dreadful year of violence in 2006, when security in the south appeared to collapse, the alliance has rediscovered a sense of confidence and believes it has regained the initiative. At the very least, say officers, NATO will not again be caught by surprise when, as expected, the Taliban step up the fight in the spring.

The International Security Assistance Force (ISAF), a NATO-led coalition of 37 countries, strolled almost casually into the heart of Taliban country as it deployed for the first time in the south and east of Afghanistan last summer. It was ill prepared for the ensuing fight that cost the lives of some 3,700 Afghans and 191 soldiers from ISAF and the separate American-led coalition, Operation Enduring Freedom.

John Reid, who was Britain's defence secretary at the time, carelessly said he would be happy if British forces completed their mission “without a shot being fired”. Instead, the first contingent to deploy in Helmand fired nearly half a million rounds of ammunition and 11,500 mortar rounds and artillery shells as paratroopers found themselves parcelled out and besieged in towns across the province.

Last September in the neighbouring province of Kandahar, a brigade-sized force, led by the Canadians but cobbled together from disparate elements, only narrowly managed to evict an estimated 1,000 Taliban fighters from the Panjwayi valley from where they had threatened Kandahar city. In Kabul, the country's capital, repeated Iraq-style suicide-bombings sapped the confidence of the government and its international supporters. The ring road connecting the main cities, the symbol of reconstruction, became perilous.

All this has changed, at least temporarily. The level of violence has decreased sharply and the ring road is safer. There have been no bombings in Kabul for months, and reconstruction teams are again active in the south. But whether this is real progress, or the result of the Taliban taking their habitual winter break, will become clear only after the snows melt. “The blood of the oppressed people and the mujahideen will bear its fruit very soon,” promised a letter from Mullah Omar, the Taliban leader, in December. Taliban commanders boast that they have 10,000 fighters, plus a swarm of thousands of suicide-bombers, ready to go into action.

Everything going their way

Nevertheless, NATO is feeling bullish. Along with Afghanistan's own forces, it is preparing “Operation Nowrouz” (new year), a spring offensive to disrupt the Taliban's spring offensive. Fighting has continued through the winter, but it has usually been at NATO's initiative. In Helmand the British have been raiding deep into Taliban areas. The Canadians have been clearing out more of the Panjwayi valley, claiming success in finding and killing key Taliban leaders and thus allowing civilians to start returning. Despite the war of words between Afghanistan and Pakistan, intelligence co-operation is improving, with the creation of a joint NATO-Afghan-Pakistan intelligence cell in Kabul.

Above all, the alliance has been energised by America's intensified commitment. On top of the surge of five brigades into Iraq, George Bush announced on February 15th that an extra brigade would be deployed in Afghanistan. He is also requesting an additional $11.8 billion in military and civilian aid over two years, mostly to pay for the expansion and training of the Afghan army and police.

Britain is beefing up its forces in the south with an extra battalion in April; additional special forces are also expected. A fresh battalion is due from Poland. Bits and bobs are being offered by other allies: six reconnaissance jets from Germany, more surveillance drones and a transport plane from Italy, military trainers from Spain and so on. But these commitments emphasise the split in the alliance. “Those with their hands in the mangle of the fighting in the south have no choice but to reinforce,” says one senior NATO officer. “The rest are trying to stay out of it.”

A recent report by the International Crisis Group, a Brussels-based think-tank, blamed the growth of the insurgency on “the desire for a quick, cheap war followed by a quick, cheap peace”. Even with the extra resources, NATO will still be stretched thin. Afghanistan is bigger than Iraq, both in terms of size and population. But the number of security forces, whether foreign troops or local soldiers, is less than a third of those available in Iraq.

The country has seen real achievements since the fall of the Taliban, not least the growth in education

and health care (admittedly more in quantity than quality) and the return of more than 3m refugees. The north and west are relatively stable. The population of Kabul has expanded eight-fold, and streets ravaged by war are bustling with street markets. People in the capital still express their strong support for the presence of international forces.

But the Afghan government remains weak, and this is as much of a problem as the strength of the Taliban. In a society wrecked by wars, poverty and illiteracy, the government lacks the human resources to run the country. In recent years it has been able to spend barely half its budget. Afghans are disillusioned by the lack of jobs and the spread of corruption, whether petty or high level. After the Taliban's collapse large parts of the country came under the control of unsavoury warlords, often linchpins of the booming opium trade. The source of nine-tenths of the world's heroin, Afghanistan is just one step away from becoming a narco-state.

When NATO belatedly expanded its remit to the turbulent south and east, the foreign soldiers were often seen as the protectors of rapacious local officials—and a threat to small poppy farmers. The Taliban seized the moment to escalate their attacks. That the alliance held its nerve is something, but success is far from assured.

“In the short term we will not remove the threat of the Taliban, but we will contain it,” says David Richards, the British general who has just completed his tour as ISAF's commander. The betting is that the Taliban will not attempt another conventional battle but will intensify ambushes and suicide-bombings. Had he had more troops last year, says the general, he could have stopped the main body of Taliban escaping the Panjwayi valley. And with more boots on the ground, he would have been less reliant on air power, with its inevitable risk of big civilian casualties.

The Afghan army is being expanded rapidly, but desertion rates are high and the quality is often poor. “When they come under fire they scatter. It's like herding cats,” says a British sergeant helping to “mentor” the Afghan army in Kandahar. The few decent Afghan army units are badly overworked. The police are in even worse shape, regarded by most Afghans as little better than robbers in uniform. The government and its backers are now scraping together a third force, the “auxiliary police” recruited locally and trained for just two weeks before being deployed.

Building the state is plainly key to winning the war. General Richards sums up the need as reconstruction, development, governance and relations with Pakistan, all wrapped up in a cloak of growing security. His central point is that there must be “synergistic” progress in all dimensions.

He has been a highly political commander, taking on the job of speaking to Pakistan's president, Pervez Musharraf, “soldier to soldier”. He claims the effort is paying off, but in the process he has irritated the Afghan government. He has also been instrumental in organising an “action group” of Afghan, ISAF, UN and other senior officials to turn government decisions into reality. The group deals with security, intelligence, strategic communications and development. The general wanted to add a fifth pillar,

governance, but was overruled by President Hamid Karzai.

America's new counter-insurgency doctrine espouses similar ideas about the need for “unity of effort” in military and civilian activity. But relations between America and Britain in Afghanistan have been tetchy. Some of General Richards's departing staff are nervous that ISAF's new American commander, General Dan McNeill, will be too “kinetic”. Rightly or wrongly, the new man is known by some as “Bomber McNeill”.

Finger in the dam

The problems that beset Afghanistan are encapsulated at Kajaki. The workers at the hydro-electric power station inhabit a surreal grey zone, sleeping with the Taliban in the villages at night and working alongside the British at the dam by day. There is an unspoken understanding by both sides to keep the plant operating; the government wants power for the cities, while the Taliban charge villagers for electricity.

First built by the Soviet Union in 1953, and upgraded by the Americans in 1975, the power station that provides most of southern Afghanistan's electricity gradually fell into disrepair. The transmission lines were blown up in 1980 by anti-Soviet mujahideen, then fixed by the Taliban government in 1996. The windows were blown out by American bombing in 2001. An American-financed project to refurbish the power station and upgrade the transmission lines is a development priority but work stopped last May when the area became too insecure. Restarting the work means reopening about 70km of road through the Taliban-controlled Sangin valley—and protecting some 100km of new transmission lines.

At Kajaki the Royal Marines are training local army recruits. Some of the hilltops around the dam are held by private militia hired by American contractors. These friendly Afghan forces complain of being low on ammunition, water and fuel (though some commanders seem to have no shortage of boys with painted nails for company). But all the fighting in Kajaki is done by the marines, who dare not tell their Afghan allies of their plans for fear of being betrayed to the Taliban.

In the view of one senior ISAF officer, “there is not a hope in hell that we can secure the road with the limited resources we have.” Indeed, the job could tie down all of the reinforcements currently planned for southern Afghanistan. The only answer, in his view, is to “engage” the population in the district to pacify the area. The offer of construction and security jobs should prove a useful enticement. ISAF officials like to display diagrams of how they intend to drive a wedge between the “irreconcilable” Taliban based largely in Pakistan and the more moderate local elements. It looks neat in the briefing rooms but in practice is a messy, ambiguous business fraught with moral dilemmas.

Chris Harris

Local recruits to scare the Taliban

A bargain to stop the fighting at Musa Qala, near Kajaki, has been particularly controversial. After months of fighting that cost the lives of six soldiers last year, British forces agreed to withdraw from the town in return for the deployment of an auxiliary police force and a promise by local elders to keep the Taliban outside a 5km radius from the town centre. The British saw it as a pioneering deal that got their forces out of static positions, gave government officials access to the town and empowered local elders.

But some senior American officials denounced it as surrender to the Taliban.

In any event, the Musa Qala deal collapsed last month when the Taliban, accusing local elders of collaborating with a NATO airstrike that narrowly missed a militant leader, stormed back into town and bulldozed part of the local police station. NATO says it got its man, Mullah Abdul-Ghafour, in a later bombing attack, but the Taliban still hold the town. Some argue that the deal was worthless because it could not be enforced; the British still say it was a success because the Taliban's behaviour angered much of the local population. The question, however, is whether displeasure at the Taliban is enough to overcome fear of the Taliban.

Matters have not been helped by the political upheaval in Helmand, which has seen three governors in a year. The current man, Asadullah Wafa, has only just started trying to assert his authority, beginning with the partial eradication of poppy crops in the province. Poverty, warlordism and rebels have made Helmand the great opium den of the world. Poppy cultivation jumped up by nearly 60% across Afghanistan last year, mostly due to increases in the southern provinces. Helmand alone accounted for over 40% of production.

The United Nations Office on Drugs and Crime expects a further rise in the south this year, but a “significant decrease” in the more stable north and centre. NATO believes that the Taliban are intimately bound up with the opium trade in the south, and that drugs money finances the insurgency. The debate is whether the government should first tackle the insurgents or the poppy growers, and whether eradication should take place before or after alternatives are in place.

What alternatives? Without security, electricity, reliable transport and access to markets, poppy farming is still the best bet. It is a crop that requires little water, does not need refrigeration and acts as a family's store of wealth: a hectare of poppy is nine times more profitable than wheat.

Ashraf Ghani, a former Afghan finance minister, argues that the real answer is not to find alternative crops but to modernise the economy. He advocates, for instance, giving preferential trade terms for textiles from Afghanistan. “Cotton will not compete with poppy,” he says, “ but T-shirts will.” Others have proposed the idea of licensing poppy production to make pharmaceutical opiates.

The Taliban keep their poppies

NATO officials worry that antagonising farmers with forced eradication will only strengthen the insurgency. The Afghan government has so far resisted American pressure for aerial spraying, preferring to rely on tractors. It claims to be targeting “the greedy rather than the needy” (for instance destroying poppy fields allegedly owned by a former police chief). No compensation will be offered. But uprooting is often a haphazard affair, usually affecting those who cannot bribe the eradication teams to pass over their plots. Given that there can be little or no eradication in Taliban areas, those who live under government control feel unfairly penalised.

Neither the drugs trade nor the insurgency can be controlled so long as the border remains uncontrolled. The Taliban still enjoy sanctuary in Pakistan, whether with the Pakistani government's approval (as Mr Karzai claims) or despite efforts to stop them (as Mr Musharraf insists). In the south-east, the Americans are reinforcing their presence on the border with Pakistan. But in the Canadian and British sectors, the frontier is unguarded. Despite NATO's planned reinforcements, there is unlikely to be more than a thin presence of special forces to watch over this part of the border.

Indeed, Helmand's governor gave warning on February 11th that 700 Taliban fighters had crossed over from Pakistan and were heading for the Kajaki dam. Up on Athens, Normandy and Sparrow Hawk, the Royal Marines like to soak up the sun during lulls in the fighting. But as spring advances, this area may soon become too hot for comfort.

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About sponsorship

The president and Congress

What chance co-operation?

Feb 22nd 2007 | WASHINGTON, DC
From The Economist print edition

Time is running out for George Bush to leave a positive mark on America. We look at the chances of reform in five key areas, starting with the schools

Taxi

Get article background

FOR as long as there have been maths tests, there have been cheats. But whereas a schoolboy caught furtively copying his neighbour's answers can expect a zero and an angry letter home, states that rig exam results are showered with federal cash. This is one reason why the No Child Left Behind Act, a noble attempt to impose discipline on American schools, needs revision before it merits an A grade.

The premise behind the law was sensible enough. Before it was passed in 2002, state education bureaucrats were reluctant to collect and publish the kind of data that would have allowed parents to make comparisons between schools, or to tell if a school was improving over time. Good schools received few rewards; bad ones had little incentive to improve. President George Bush sought to change that.

Under No Child Left Behind, students must be tested on maths and reading every year between the ages of eight and 13, and once in high school. Test results must be published and broken down by race. Schools that fail to show “adequate yearly progress” face penalties. Parents of children at consistently failing schools must be allowed to move them to better ones.

All good stuff. But there are catches. Federal subsidies to the states depend on students meeting standards that the states themselves set. States thus have a multi-billion-dollar incentive to game the system. In Arizona, for example, only one-fifth of eighth-graders were rated “proficient” at maths after taking the state test in 2003. Two years later, that proportion had magically tripled. Does this mean that the test got easier to pass? “Yes,” says Janet Napolitano, Arizona's plain-talking governor.

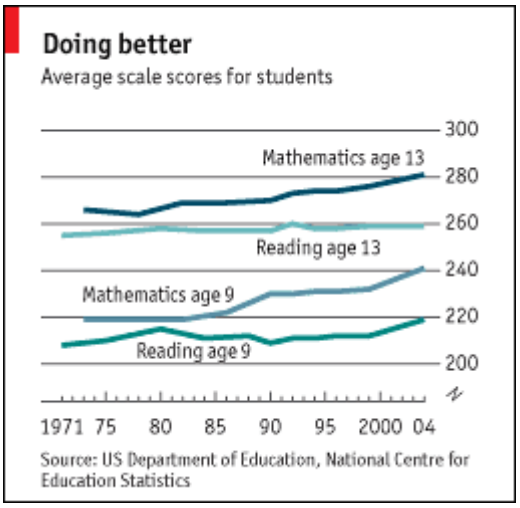
Joel Klein, the man in charge of public schools in New York City, lists other perverse incentives. States are rewarded for increasing the proportion of students who pass their exams, but not for raising a child's score from abysmal to nearly-good-enough-to-pass, or from just-passed to brilliant. So they are tempted to lavish attention on those on the cusp of passing, while neglecting both the weakest and the strongest students. Mr Klein argues that schools should instead be judged by the progress their pupils show, regardless of whether they cross an arbitrary threshold. He plans to introduce such a system soon in New

York.

None of this means that No Child Left Behind is not working. The states may be gaming the system, but the extra data they have been obliged to produce are not meaningless; they can help parents to compare their local schools with others nearby, and allow teachers and principals to make more informed decisions. The act's provisions for rescuing lousy schools have also done some good. For example, when the Isaac Middle School in Phoenix, Arizona, showed consistently terrible results, the authorities sent in a new principal, Armando Chavez. “There was a lot of fighting,” he says, “and one time, the police had to physically take a student away.” Mr Chavez arrived with two new assistant principals and a mandate to “restructure” the school. He imposed clear punishments for misbehaviour and challenged the students academically. The climate is much better now, he says.

Nationally, the best indicators of progress come from federal tests the states cannot tamper with. According to the National Assessment of Educational Progress (NAEP), maths scores for nine-year-olds improved by nearly two percentage points between 1999 and 2004, while those for 13-year-olds rose one point. Seventeen-year-olds, who were not affected by No Child Left Behind, showed no improvement. Reading scores for nine-year-olds improved by 1.4 points over the same period; 13- and 17-year-olds got no better.

This suggests—though it does not prove—that No Child Left Behind has been a modest success. Given the challenges, such as a huge annual influx of immigrants' children with shaky English, things are going pretty well, says Margaret Spellings, the education secretary. She says it is a “moral imperative” to make schools more accountable, but she is realistic about the limits of federal power. Schools are largely a state and local responsibility. The federal government can persuade—it provides 8% of a typical state's education budget—but it cannot compel.



The law is up for review this year. Congress is likely to tinker with it, probably soon. On February 13th a bipartisan commission made some useful recommendations. It echoed Mr Klein's call for measuring progress less crudely. It also urged that teachers be individually assessed according to how much their pupils learn. This will be controversial.

America has many excellent public schools, but many awful ones, too. The toughest obstacle to improving the worst is the strident opposition of the teachers' unions to meritocracy. In many states bad teachers are nearly impossible to sack. Pay and promotion are often by seniority. So the worst teachers linger for ever, while many talented people who might otherwise become teachers shun a profession where their talents will be neither recognised nor rewarded.

The unions' dead hand

All this would be technically simple to fix. Tenure could be abolished, principals could be allowed to hire and fire freely and teachers could be paid by results. School funding could also be made dependent on how many parents choose to send their children to a particular school, so that good schools would expand and bad ones would close or be taken over. But all this is politically impossible—especially with the Democrats, who grovel to the teachers' unions, in charge of Congress.

No Child Left Behind originally passed with bipartisan support because Republicans liked the tests and Democrats liked the extra money Mr Bush threw in to sweeten the deal. This year Democrats will push for yet more money, most of which will be unnecessary, and will strive to iron out the worst anomalies in the tests. But will they let bad teachers be sacked? “That's a sticky issue,” says a well-placed Democrat.

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Immigration

One more shove

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Congress is once again preparing to deal with the immigration mess

THE most dismal failure of the dismal 109th Congress was the non-reform of immigration. This is one of America's most chronic problems, with 12m illegal immigrants living in the shadows, more streaming over the border every day and many border towns buckling under the strain of so many non-citizens. Public pressure to "do something" is intense.

George Bush pushed hard for "comprehensive" immigration reform (meaning a combination of a path to citizenship for illegals and tougher border enforcement). John McCain and Teddy Kennedy crafted a bipartisan bill that passed the Senate by 62 to 36. But then the Republican-dominated House wrecked the whole thing in a fit of crude nativism.

Thankfully, the reformers have not been deterred. There has been a great deal of "scurrying about" behind the scenes, according to one insider. An odd coalition of business groups, trade unions and civil-rights organisations is pushing hard for reform under the umbrella of the Alliance for Immigration Reform 2007. An equally odd coalition of White House operatives, Democratic leaders and reform-minded Republicans is also working in the same direction. A new version of the McCain-Kennedy bill could be launched as early as mid-March. And Harry Reid and Mitch McConnell, the two parties' leaders in the Senate, have said that immigration will be one of the first ten bills they will consider. This time the chances of success are higher than last.

The main reason is the new Democratic majority in the House. The most virulent opposition to reform came from Republican House members who were obsessed with cracking down on illegals and building a 700-mile (1,125km) fence along the border with Mexico. Now that the Democrats are in the majority, Zoe Lofgren, the head of the sub-committee on immigration, thinks a deal is at least a possibility.

The reformers are also adopting a tougher tone. The new McCain-Kennedy bill will put more emphasis on beefing up the border, punishing errant employers, enforcing the law and assimilating new immigrants. It will also try to rebut Republican charges that it rewards lawbreaking and offers amnesty. Two current ideas are to impose a hefty fine (up to $5,000) on illegal immigrants who want to become legal, and to make illegals return to their countries of origin ("touching base", in the jargon) in order to apply for legal entry.

The reason for this toughness is that comprehensive reform has little chance of passing both Houses on the backs of Democrats alone. A significant number of so-called blue-dog Democrats from conservative districts have every reason to steer clear of such controversial legislation. There is also a strong undercurrent of protectionism in the Democratic Party, which suspects immigrants of holding down American wages and stealing American jobs. Insiders calculate that they need about 20 Republican votes in the Senate and 40 in the House.

The reformers will have to overcome some big political and practical problems. Why should Democrats co-operate with Mr Bush on immigration, when they can wait until they capture the White House in 2008 and solidify their lead among immigrants for a generation to come? And why should congressional Republicans change their minds on this most emotive of issues? The vast majority of these members represent white conservative voters who regard immigration reform as a reward for breaking the law and a guarantee of the "Mexification" of American culture. The minority who represent more mixed districts are well aware that 70% of Latinos voted Democratic in 2006.

The practical problem is that the proposed bill will become so tough that it is self-defeating. Why should illegal immigrants come out of the shadows if they have to "touch base" and put themselves in the hands

of America's notoriously slow and inept bureaucracy? And why, for that matter, should liberal interest groups support a bill that might seem punitive?

AP

Still, it would be a mistake to write the reformers off. The Democratic leadership risks provoking a backlash if it refuses to put its weight behind the bill, particularly among Latinos, who desperately want the mess cleared up. And the Republican Party also contains some powerful pro-immigration forces. American business strongly favours immigration reform: parts of the economy such as hotels and agribusiness depend on immigrant labour. “Big tent” Republicans also favour reform.

Karl Rove, Mr Bush's chief strategist, has long pointed out that it is stupid to alienate America's fastest-growing minority—particularly one as culturally conservative as the Latinos. In a swathe of states that Republicans need to retain the presidency, their numbers are crucial: New Mexico is 43% Latino, Texas 35%, Nevada 24%, Florida and Colorado 20%.

The November elections have also strengthened the hand of the big-tent Republicans. Several high-profile immigrant-bashers, such as Arizona's J.D. Hayworth and Indiana's John Hostetler, lost their elections. And John Boehner, who was one of only 17 House Republicans to vote against the party's border-protection act, has become minority leader.

Over the next few months everything will depend on the delicate politics of bipartisanship. Immigration reform gives both sides the chance to blame the other for failure. But it also gives both sides a chance to share the praise for a wrenching but necessary reform. The stakes for everybody involved, not least 12m illegal immigrants, could hardly be higher.

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The environment

Green sums

Feb 22nd 2007
From The Economist print edition

In search of a compromise on an ever hotter topic

GLOBAL warming, George Bush said in his most recent state-of-the-union address, is a "serious challenge". Congress seems to agree. The Senate alone is already considering four proposals to tackle the problem, and more are on their way. Mr Bush also said that he would like to reduce America's oil consumption. That seems to square with the ambitions of Nancy Pelosi, the new Democratic speaker of the House of Representatives, who has set up a select committee to address the subject. But this common interest in environmental issues will not necessarily translate into resolute action. Indeed, the fact that greenery has suddenly become a hot topic may make compromise more difficult.

"There is a time to reap, and a time to sow," says Josh Dorner of the Sierra Club, an environmental pressure group. He and other activists would prefer to spend the next year or so preparing the ground for vigorous environmental legislation under the next president rather than settling for an immediate but meagre harvest. After all, the leading presidential contenders in both parties favour bolder steps than Mr Bush, such as mandatory caps on America's emissions of greenhouse gases. Neither the pressure groups nor the Democrats who control Congress have much interest in defusing an issue that might stir up voters and their money before the next election. Instead, they are likely to push for small, symbolic measures that underline their concern for the environment without jeopardising their future plans.

Legislation on global warming certainly does not fit that category. It is like health care, says Paul Bledsoe, a former Democratic aide who has worked on both issues, in that everyone agrees it is a problem but disagrees about the solution. Like Mr Bush, most Republicans in the Senate dislike the idea of emissions caps. One of them, James Inhofe, has vowed to filibuster any law that includes them. Hammering out a deal on such a vexed issue can take ages. Congress had debated the Energy Policy Act it eventually passed in 2005 for four-and-a-half years, for example. That experience, observers say, has left many members suffering "energy fatigue".

There is more common ground on the subject of fuel efficiency. Mr Bush has proposed raising requirements for carmakers by 4% a year, albeit with all sorts of conditions. The same number features in bills with bipartisan backing in both the House and the Senate. Voters are keen too: 72% support stronger standards, according to a forthcoming poll from the Energy Security Leadership Council, a group of anxious grandees. But John Dingell, the chairman of the relevant committee in the House, represents the suburbs of Detroit, America's "motor city". The car industry is already struggling, and unions are implacably opposed to anything that might make matters worse. That will leave Democrats who rely on support from the labour movement in a quandary.

CNP

The least controversial idea is the promotion of renewable power, from windmills, solar panels and the like. Bills before both the House and Senate would require America's power firms to generate 20% of their electricity from such sources by 2020. Twenty-three states and Washington, DC, already have "renewable portfolio standards", and many of them seem to be profiting from booming investment in greenery. Politicians see renewables as a vote-winner, judging by the number of uplifting shots of windmills that featured in campaign ads last year. Any downside, in the form of higher power bills, would probably be felt only in the distant future. But there would not be much upside either, since renewable power is already growing like gangbusters, thanks largely to expensive subsidies.

A more useful alternative would be to set up a formal registry of America's emissions of greenhouse gases. Republicans and their backers in industry would accept that more readily than a cap on emissions. But Democrats and their green supporters would see it as clear progress towards such a cap. And if Mr Bush is really worried about global warming, he could hardly veto such an anodyne measure.

Emperors of emissions

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Health care

A small dose

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Congress will only nibble at health-care reform

FOR the first time in years, Washington is talking about big changes in health policy. In his recent budget, George Bush took aim at the $200 billion tax subsidy for employer-purchased health insurance. He wants to replace it with a standard (and limited) deduction for everyone who buys insurance, which would help control health-care costs and boost coverage. His budget also chops at Medicare, the government's health plan for the old, cutting payments to providers and making richer old folk pay higher insurance premiums.

Top congressional Democrats have denounced both proposals, but are themselves talking big about health care. Pete Stark, the top man on health in the House of Representatives, wants to move America towards a single-payer system by allowing everyone to buy into Medicare. That idea has scant support beyond the party's extreme left. Ron Wyden, a senator from Oregon, is pushing a more centrist approach. He wants to cut the link between employment and health care by replacing today's tax subsidy with a standard health-care deduction and subsidies to help poor people pay for insurance, which everyone would have to buy.

The debate in Washington is driven partly by the states, several of which have ambitious plans to cut the ranks of the uninsured. Unions and business groups are also demanding action. Lee Scott, head of Wal-Mart, the world's biggest retailer and a company often pilloried by the political left, recently joined forces with Andy Stern, a top union leader, to push for universal health coverage by 2012.

It is already clear that health-care reform will loom large in the 2008 presidential election. The leading Democratic candidates have all promised plans for universal coverage. John Edwards has already produced one. His is a centrist proposal—individual mandate, subsidies and so forth—but with a sop to the party's left. Private insurers will have to compete with a public plan modelled on Medicare.

The shadow of 2008 bodes ill for bold action now. Most Democrats would be loth to back radical change when a different scheme might soon be led by a Democratic president. Nonetheless, a few congressional decisions this year will be important. One is the fate of SCHIP (State Children's Health Insurance Programme), the government health plan for children just above the poverty line.

Washington gives the states around $5 billion a year to fund SCHIP, letting them decide how to spend it. Some use the money to insure children further up the income scale. Others help poor uninsured adults. The plan must be re-authorised this year, and health-care experts reckon that SCHIP's funding must be increased by some $13 billion-15 billion over five years to maintain the current levels of coverage.

Mr Bush, however, wants to add only $5 billion while tightening the strings attached to the money. These would cripple the states' efforts to broaden insurance coverage. They are unlikely to become law, since congressional Democrats are determined to add more money to SCHIP and retain its flexibility. But their promise to stick to pay-as-you-go budget rules means this extra cost must be offset elsewhere.

Budget constraints will clearly limit the Democrats' ability to expand health coverage. Less obvious is whether they will try to control costs. Mr Bush's budget calls for cutting almost $70 billion from Medicare over five years. Many left-leaning health wonks think his ideas, especially more means-testing, make sense. But top congressional Democrats are unimpressed. Real progress demands more than that.

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Social Security

Still the third rail

Feb 22nd 2007 | WASHINGTON, DC
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A deal on Social Security reform is a political long shot

Alamy

DURING his 2004 re-election campaign, George Bush promised to prove that it was possible to touch Social Security and live. He would fix the state pension scheme in his second term and, in doing so, shift America towards a system based on personal retirement accounts.

That effort failed miserably. Republicans were tepid; the Democrats, as one, opposed it, demonising the president for trying to "partially privatise" America's most popular government programme. Now that the Democrats control Congress, are they any more willing to strike a bargain?

Fixing Social Security would be much less complicated than trying to mend Medicare (see article). The pension plan's long-term financial gap, the difference between promised benefits and likely revenues, is some 1.3% of GDP, less than one-quarter the size of the hole in Medicare. And the ingredients of a reform package are no secret. The system's finances can be fixed either by raising revenue or reducing promised benefits. A compromise will require some of both. Benefit cuts will have to be progressive: politicians of all stripes are determined that poorer Americans should not lose out. Equally, to get Republicans on board, new revenues may have to be linked to individual accounts.

Several plausible compromise plans already exist. Some create individual accounts as an obligatory saving scheme separate from Social Security; others raise more revenue from the payroll tax through which the scheme is funded, but put it in private accounts.

Although the technical routes to agreement are obvious, the political path is less clear. A lot of Democrats still have their heads firmly in the sand. Max Baucus, a top man on fiscal matters in the Senate, said recently that he wants to fix Social Security "without raising taxes and without cutting benefits". Many of his colleagues are unwilling to accept that Social Security's finances cannot be shored up simply by raising taxes on the rich. Others see no partisan advantage in giving an unpopular president any kind of victory. And most doubt Mr Bush's willingness and ability to compromise.

The Bush team has been sending mixed signals. Hank Paulson, the treasury secretary, and other top officials claim Mr Bush wants to discuss entitlement reform with no "preconditions". Yet Dick Cheney, the vice-president, recently made it clear that the White House would not raise taxes. Grover Norquist, head of Americans for Tax Reform and one of the most prominent tax-cutters, even opposes mandatory contributions to individual accounts, arguing that such forced saving is "awfully close" to a tax increase.

To get a Social Security deal within the next two years, Mr Bush must have the courage to ignore his conservative base and Democrats must show the maturity to work with the White House in good faith. The chances of either are slim.

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City planning

Tunnel vision

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Mayor and governor are mud-wrestling over Seattle's waterfront

AP

There's a great view here somewhere

IT SHOULD be among the most beautiful cityscapes on the west coast: a mural of distant mountains, piers jutting into sun-flecked Elliott Bay and giant orange cranes plucking containers from freighters. Overlooking Seattle's waterfront, however, is a noisy 1950s elevated highway in hideous grey concrete.

The elevated highway—known in Seattle simply as “the viaduct”—is also a hazard. It was damaged by an earthquake in 2001, and engineers believe that another quake would destroy it. It needs to be replaced. But with what, and how?

Seattle's mayor, Greg Nickels, a Democrat, wants to replace the viaduct with a tunnel. He argues that this would make the waterfront more attractive while accommodating the 110,000 vehicles now using the viaduct each day. Business leaders, labour groups and many others agree, but the problem is cost. The first plan carried a luxury tab of $4.6 billion. Then, earlier this year, Mr Nickels came up with a surface/tunnel hybrid, or “tunnel lite”, a narrower, less complex tunnel that would cost $3.4 billion.

On the other side of the debate are members of the state legislature and Washington state's governor, Christine Gregoire, who is also a Democrat. They want to replace the viaduct with a bigger, sturdier elevated highway. They have leverage: state money would provide $2.4 billion towards a tunnel or most of the cost of a replacement viaduct (estimated to be $2.8 billion). Believing that Mr Nickels has ignored the tunnel's high price, Ms Gregoire has threatened to withdraw funding for any waterfront roadway if city leaders do not come to their financial senses.

Mr Nickels, who adamantly opposes a new viaduct, has countered Ms Gregoire with his last-minute suggestion for a downsized tunnel. He has arranged an “advisory” city vote, due on March 13th, in which city residents will say whether they support a tunnel or a new viaduct (or, amazingly, both). And he has all but said that if he doesn't get a tunnel Ms Gregoire and her $2.4 billion can take a hike.

The spectacle of the bulky, dark-haired Mr Nickels mud-wrestling with the diminutive, honey-haired Ms Gregoire has not been edifying. “These people are going to go down as some of the worst urban leaders in America,” comments Bryan Jones, an expert on public policy at the University of Washington. At present Ms Gregoire is coming off worse. Now in her third year in office after an election so tight that it had to be decided in court, she had gained respect as an effective legislative manager. But her ambitious education and health-care plans have disappeared in the viaduct's shadow. And the bitterness of the fight is expected to sour debate over future projects in and around Seattle, including the need to replace a

vital floating bridge that carries traffic to the city's eastern suburbs.

A report on February 13th from the state's Department of Transportation stated bluntly that Mr Nickels's slimmed-down tunnel would not work as a safe, effective roadway. A spokesman in the mayor's office promptly dismissed the report as “political” and revealed the mayor as immovable. Seattle's tunnel has become a trip to political hell. All aboard.

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America's next president

Waiting for Al

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As voters weary of the front-runners, what a chance for Al Gore

ENOUGH already. The primaries are 11 months away and the race is already growing stale. The citizens of Iowa and New Hampshire are longing for the day when they can visit Denny's without having to meet Hillary or Rudy. And the press is busy recycling the same old stories. Can Barack Obama run for president and give up smoking at the same time? Will Hillary hand her Senate seat to Bill if she wins? Is America ready for a Mormon president? Or a black? Or a woman? Or a man who once dressed as Marilyn Monroe?

There is no shortage of money or ideas: the candidates' treasure chests are overflowing and the think-tanks churn out policy papers. But there is a severe shortage of attention. People will not be able to watch the same soap opera, endlessly repeated on 24-hour cable news and pored over in the blogosphere, for months on end without getting sick of the main characters.

Which means that there is a huge opportunity for somebody to arrive late and steal the show. The late entrant will not only have the advantage of being a fresh face. He or she could also change the whole dynamic of the race, gaining enough momentum to storm through Iowa and New Hampshire.

Step forward Al Gore. Mr Gore has enough of a national profile to command instant credibility. He has rich friends to finance him. He will also command plenty of attention in his own right over the next few months: his film “An Inconvenient Truth” could win an Oscar for best documentary on Sunday, and he may be up for the Nobel peace prize in the autumn.

Mr Gore is the ideal candidate for the Democratic stalwarts who turn out to vote in the primaries. He came out strongly against invading Iraq. He has spent the past six years warning the world about global warming. And he was robbed of victory in 2000 by the man whom the Democrats loathe above all others. What better way of wiping out the Bush era than replacing him with the man who should have been president?

Mr Gore is adamant that he does not want to run again. But will he be able to resist? It would be one of the great dramas of American political history. And James Carville, keen observer of politicians, says that, for them, running for president is rather like having sex for normal people: it is not something that you do just once if you have any say in the matter.

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Lexington

Pelosi rides high

Feb 22nd 2007
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Madam Speaker is turning out to be one of the Democrats' best assets

Kevin Kallaugher

SO FAR, the record has been impressive. Give or take a few fumbles—notably her doomed campaign to make her crony, John Murtha, majority leader—the successes have far outweighed the failures. Nancy Pelosi, the new speaker of the House of Representatives, has pushed through a popular raft of reforms in double-quick time. She has masterminded a vote of no confidence in George Bush's new Iraq policy, allowing her troops to vent their anger without cutting off funding. And she has done all this while looking cool and stylish.

But can she keep it up? Life at the top of the greasy pole is going to be a lot harder from now on. She began her new career in the best possible circumstances, with her party cock-a-hoop to retake Congress after a decade in the wilderness. Her party's policies, too, were all poll-tested crowd-pleasers. A higher minimum wage! Cheaper student loans! Better health care! Who but a Scrooge could oppose them? The minimum wage has not been raised for a decade (many Republicans voted for the measure). Cheaper student loans are always a winner, though they will encourage colleges to raise their fees.

Now Ms Pelosi will have to deal with much thornier issues, such as immigration reform: issues that divide the Democratic base and require tough choices rather than generous gestures. If she co-operates with Mr Bush in dealing with these thorns, she risks handing him domestic victories that could help revive his flagging presidency. If she fails to co-operate, she risks becoming the do-nothing head of a do-nothing Congress. One of the clearest messages from the November elections was that the voters want Congress to solve pressing problems rather than engage in partisan point-scoring.

The issue of the Iraq war is also going to get much trickier. Ms Pelosi faces relentless pressure from her base—and from many of her colleagues in Congress—to confront Mr Bush head-on. But it is one thing to engineer a symbolic vote of no confidence in an unpopular policy, and quite another to start tying the hands of a president during wartime.

Mr Murtha—in many ways Ms Pelosi's right-hand man on Iraq—has suggested that the Democrats will finesse the problem by pursuing what critics call a “slow bleed” strategy. They will avoid a head-on confrontation but will, instead, slowly limit Mr Bush's options—for example, by linking support for funding to strict standards for resting, training and equipping combat forces. But this is a dangerous strategy:

doubly dangerous now Mr Murtha has been fool enough to spell it out. It risks the charge that Congress is trying to micromanage the war (conservatives say it is the most meddlesome attempt to tell the president what to do since the civil war). It also risks the even more damaging charge that it is trying to make Mr Bush's policy fail.

Ms Pelosi's circumstances will also get a lot more difficult. The party will find it harder to maintain its lustre as it starts handing out pork to Democratic interest groups; Democratic lobbyists are swarming over Capitol Hill like locusts at the moment. It will also get more fractious as strains grow between blue-state liberals (who want to destroy Mr Bush) and blue-dog Democrats (who represent districts where there is still residual respect for the president). The press will tire of writing stories about Ms Pelosi's dress sense and her taste for chunky pearls.

She will see her power diminish as attention shifts towards the presidential race, and eventually to the party's new champion. She will also discover—as Newt Gingrich did before her—that it is much more difficult to assert power from Congress than it is from the White House. Congress is a potentially unruly rabble. The White House has a unified power structure and a powerful megaphone.

These problems will certainly batter her image. But it would be a mistake to assume that she will be crushed by them. Ms Pelosi's most notable achievements over the past few months have been behind the scenes, not on the national stage—and these have laid the foundations for a successful speakership.

The Gingrich model

Since the 1970s the congressional Democrats have been dominated by powerful committee chairmen who did pretty much what they wanted when they wanted. Ms Pelosi has brought these barons under control. She has imposed six-year term limits on them. She has forced the likes of John Conyers to button their lips about impeaching Mr Bush. And she has eaten into the chairmen's prerogatives, notably by creating a select committee on climate change that will inevitably trespass on the turf of the energy committee.

All this suggests political skills of a high order: the chairmen had been biding their time in the wilderness in order to resume their jobs for life. It also suggests that Ms Pelosi is thinking of the long term. She can now impose a much more unified message on her party than any previous Democratic speaker, and can use her patronage to advance a younger cohort of chairmen.

It is true that many of these ideas, including term limits, were pioneered by Mr Gingrich. But if Ms Pelosi can imitate Mr Gingrich's successes without emulating his failures, that will be no bad thing. She lacks Mr Gingrich's personal foibles as well as his eccentric genius (though her reliance on Mr Murtha is troubling). She also lacks his raging ego. Mr Gingrich failed in his battles with Mr Clinton because he saw himself as America's first prime minister—a man who could rule Washington from Congress.

Ms Pelosi has Mr Gingrich's example to contemplate if she is ever tempted to over-reach. She also seems to have an instinctive understanding of the limits of her role. She knows that history will judge her not merely as the first female speaker of the House. It will also analyse how well she prepared the ground for the Democrats to retake the White House in 2008.

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Canada

The strange disarray of Quebec separatism

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Federalism can sometimes work—even in Canada

Claudio Munoz

THE 7m or so people of Quebec are notoriously unforgiving of their ice-hockey teams. A mediocre streak, such as the Montreal Canadiens have suffered recently, is greeted by calls for players to be traded or the management sacked. They are far more indulgent of their provincial governments. They tend to get a second term no matter how the first one went.

For a long time Jean Charest, the province's Liberal premier since April 2003, looked likely to buck this trend. During most of his first term his party's approval ratings, and especially his own, have languished. But this week he called an election for March 26th, and the polls suggest he is well placed to win it. That says quite a lot, not so much about Mr Charest, but about the disarray of the separatist opposition and the recent quiet effectiveness of Canadian federalism.

That Quebec should remain a part of mainly English-speaking Canada can never be taken for granted. Ségolène Royal, France's gaffe-prone Socialist candidate for president, stirred up Canadians recently by calling for self-determination for the French-speaking province. A referendum on independence in 1995 was lost by a margin as thin as a maple leaf, with 49.4% voting in favour. Some 45% of Quebeckers still tell pollsters they would vote Yes in another referendum. For much of Mr Charest's term the pro-independence opposition, the Parti Québécois (PQ), has been way ahead in the opinion polls.

That reflected disappointment with the Liberals. Mr Charest promised radical change. He would slash taxes in the most heavily taxed jurisdiction in North America while also improving health care through a "re-engineered" state employing fewer bureaucrats and with the private sector providing many public services. But his tax cuts amounted to much less than the promised C$1 billion ($850m) a year, while the attempts to rationalise services were often unpopular. His administration has been steady but uninspiring.

Two things have come to his rescue. The first is the opposition's own troubles. The PQ's leader, Bernard Landry, a tough and experienced former premier, quit in a huff after receiving only 76% in a confidence-vote of party members in 2005. His party's supporters hoped that his young replacement, André Boisclair, would rejuvenate the separatist movement.

Instead, Mr Boisclair has managed to alienate many Quebeckers. Social conservatives were offended by

his admission that he used cocaine while a minister in Mr Landry's government. He is also openly gay. Others dislike his thin-skinned haughtiness and infuriating evasiveness. “Where does he stand on any issue? It's hard to know,” says Christian Bourque of Léger Marketing, a polling firm.

Mr Charest's other boost has come from the rest of Canada. It has helped that the country's economy is thriving. Unemployment in Quebec is still more than a point above the national average, but since 2003 it has fallen from 9.1% to 7.7%. The biggest helping hand has been that of Stephen Harper, who became Canada's prime minister in January 2006.

Mr Harper is a Conservative. But federal and provincial politics often run along separate tracks in Canada. With a solid base in the west, Mr Harper quickly concluded that his best hope of turning his current parliamentary minority into a majority lay in winning more seats in Quebec. One way to that was to help Mr Charest (himself a former federal Conservative minister) beat back the separatist threat—a desire close to the heart of most English-speaking Canadians.

Mr Harper has been a regular visitor to the province, often bearing gifts. These were both material—extra federal funds—and symbolic. Last autumn he stole some of the separatists' clothes by pushing through Parliament a motion recognising that Quebeckers “form a nation within a united Canada”. This month he was back in the province with C$350m to fund Quebec's climate-change plan. The federal budget, on March 19th, may offer more.

Mr Harper's prim social conservatism does not go down particularly well in more free-wheeling Quebec. But good relations between Quebec City and Ottawa are a welcome change in a province used to constant bickering between the two. They also deny the separatists a favourite campaign theme: that Canadian federalism cannot work to Quebec's benefit.

Support for independence nowadays has much to do with calculation of the costs and benefits, says François Rocher, a political scientist at the University of Ottawa. “Nationalism driven by resentment and cultural insecurity is in decline. The issue is more and more, ‘What can we do better by ourselves?'”

In this cautious atmosphere, the PQ might be wise to show caution of its own. But hardline nationalists inside Mr Boisclair's party do not want him to campaign simply as an alternative to the Liberals. They want to put sovereignty at the centre of the campaign, and to promise an early sovereignty referendum if the party wins.

In the province's current mood, that could alienate the 20% of undecided voters in the middle. It may also push votes towards a third party, Action Démocratique du Québec. Formed by disaffected Liberals, this describes itself as “autonomist”—a constitutional half-way house that suits Quebec's newly pragmatic nationalism. It suffers the usual fate of third parties in first-past-the-post voting systems, doing better at by-elections than in the real thing. But its young leader, Mario Dumont, is popular, and the voting habits of Quebeckers are not as predictable as they used to be.

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Venezuela

Freedom to agree

Feb 22nd 2007 | CARACAS
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Silencing dissenting views little by little

Get article background

SINCE he took office in 1999 Hugo Chávez, Venezuela's leftist president, has steadily centralised power in his own hands. But his officials have always been able to counter accusations that he is an autocrat by pointing to a pugnacious and largely free opposition media. That argument looks increasingly threadbare.

AP

Broadcasting their master's voice

Shortly after winning a presidential election in December with 63% of the vote, Mr Chávez announced that he would not renew the licence of one of the country's oldest broadcasters, Radio Caracas Televisión (RCTV), when this expires on May 27th. The owner of RCTV, Marcel Granier, is an outspoken critic of Mr Chávez. The decision appeared to be “a form of censorship [and] a warning to others”, in the view of José Miguel Insulza, a Chilean Socialist who is secretary-general of the Organisation of American States. The opposition press faces increasing harassment. But government-owned media are multiplying.

The government accuses RCTV of breaking broadcasting laws, of discriminating against Mr Chávez's supporters and even of conspiring against the state. Yet it has made no effort to air its case in the courts. The broadcasting regulator, Conatel, has remained silent on the issue. Its director, Alvin Lezama, was sacked not long after the RCTV decision was announced, and the body merged into a new telecommunications ministry.

Tal Cual, an evening paper whose editor, Teodoro Petkoff, snipes at the government from the centre-left, was this month fined for a humorous editorial addressed to the president's nine year-old daughter, Rosinés. Mr Chávez frequently refers to her in public. He ordered that the country's coat-of-arms be changed after she said the white horse on it was “looking backwards”. Laureano Márquez, a humorist, suggested in *Tal Cual* that Rosinés might ask a few other favours: “that he not get so cross with those of us who don't think like him”, for instance. He and the paper were prosecuted for violating the child's “honour, reputation [and] private life”.

Venezuela's four privately owned national TV channels showed bias in their coverage of the country's bitter political conflict of 2001-04. They supported a coup attempt that briefly ousted the president in 2002, and notoriously failed to cover demonstrations calling for his return. Mr Chávez has frequently threatened them with drastic measures “even though they'll call me a tyrant”. His government has approved vaguely worded and potentially repressive media legislation, apparently to encourage self-censorship.

Two of the four took the hint. Venevisión, which is controlled by Gustavo Cisneros, a prominent Venezuelan businessman, and Televen (always the mildest) scrapped programmes run by opposition journalists and toned down their news coverage. These channels' licences may, it seems, be renewed. The fourth—Globovisión, a 24-hour news channel—is newer and its licence is not yet up for renewal. The result is that “as from June, Globovisión will be the only TV signal broadcast out of Caracas that is not pro-Chávez,” says Andrés Cañizales, a media critic. And Globovisión already complains of constant official harassment.

Meanwhile, the government has vastly expanded its own media holdings. It runs three national TV

channels, as well as Telesur, an international news channel set up by Mr Chávez as an answer to CNN. It recently bought CMT, a small Caracas channel, to broadcast Telesur at home. It has pumped money and other resources into “alternative” and “community” media, most of which are dependent on the state and are unlikely to adopt a critical stance.

Mr Chávez this month relaunched his weekly “Hello President” programme as a 90-minute nightly radio show, with a TV version once a week. Promising “exclusives” in every edition, he used the first to announce a new decree against “hoarders and speculators” with six-year jail terms for offenders. He also regularly obliges all TV and radio stations to broadcast his rambling speeches live.

Programming on state media is heavily slanted in favour of the government. Dissident voices, even from within the *chavista* camp, are mostly excluded. A study by the Global Media Observatory, a Venezuelan NGO of leftist inspiration, found coverage of December's election by the main government channel, VTV, to be even less balanced than that of RCTV. On several occasions, the study noted, VTV even suspended its news programmes in order to carry live coverage of government events, “especially the inauguration of public works”.

Responsibility for regulating the media now lies with Jesse Chacón, the telecommunications minister. A former army officer, he took part in a bloody coup attempt against a democratic government in 1992. (Mr Chávez led another coup attempt in the same year.) He says that the government will use RCTV's slot for a “public service” channel. The opposition is sceptical, pointing out that it has failed to do this with any of its other channels. After May 27th, it will be up to the government to prove them wrong.

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The Caribbean

Beyond a boundary

Feb 22nd 2007 | PORT OF SPAIN
From The Economist print edition

Hopes for a legacy from the cricket field

KENSINGTON OVAL in Barbados is one of the world's most traditional cricket grounds. Earlier this month, a team of veteran West Indian players led by Sir Vivian Richards, their former captain, took to the field to mark its remaking as a modern stadium after a $68m revamp. Across the English-speaking Caribbean construction workers are racing to complete similar refurbishments before the start on March 5th of cricket's world cup—the region's biggest-ever sporting event.

AP

A great stadium awaits the rum and a revival of Barbadian cricket

It is costing around $870m. Many of the host countries are small and indebted. Much could go wrong, from accommodation and transport hassles to security scares. But if all goes well, the cup will leave a useful (albeit expensive) legacy of sports facilities, know-how and maybe some new sources of future tourists. Except for the Netherlands, the 16 participating countries were all once part of the British empire. They include India. After Britain, the biggest ticket sales abroad have been in the United States—to Indian and other cricketing diasporas.

Malcolm Speed, the chief executive of the International Cricket Council, has expressed fears of “logistical problems”. Matches are being played over two months in nine separate countries. The distances involved are not trivial: Jamaica and Guyana are 2,400km (1,500 miles) apart. The biggest problem may be moving fans in eight days at the end of April from second-round matches in Grenada and Barbados to semi-finals in St Lucia and Jamaica and back to Barbados for the final.

There are normally only 300 daily airline seats from Jamaica to the other islands. Several regional airlines have been shedding capacity. Some well-heeled Australians have chartered a Boeing 767 to fly them around. Only Jamaica has enough hotels to accommodate fans with comfort. The American State Department has warned students planning a Caribbean spring break to make sure they have a bed.

For many fans, cruise ships will supply both accommodation and transport. The Barbados government has chartered one that sleeps 3,000; it will also sail to matches in Grenada and St Lucia. At least 13 other ships will visit the island, some booked by groups from Australia or South Africa. A bed-and-breakfast industry has been brought into being—and will outlast the cup. Another legacy is five new stadiums, financed by China, Taiwan or India, and others that have been modernised.

Local security services have received extra training. Lists of arriving passengers will be screened, with

help from American officials. Partly with security in mind, many visitors will require a special visa costing $100. That bureaucratic inconvenience worries hoteliers.

The biggest letdowns may be for locals. Caribbean cricket is normally big on atmosphere. Fans blow conch shells, bang out a rhythm on steel brake-drums, and tote all-day liquid picnics of cold beer and rum. Everywhere the smell of grilling food is in the background. Security may preclude some of these pleasures. And the West Indies team is a shadow of the sides that dominated world cricket in the 1960s and, under Sir Vivian, in the 1970s.

The Caribbean habit is years of delay and committees, then a last-minute dash. With luck and a smile, all usually plays out. This time the stakes are high, off the field as well as on it.

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Colombia

Paramilitary politics, and other perils

Feb 22nd 2007 | BOGOTÁ
From The Economist print edition

An embarrassment for Álvaro Uribe

STUBBORNNESS is one of Álvaro Uribe's qualities but it can sometimes be a defect. When last November María Consuelo Araújo, his young foreign minister, was caught up in an escalating scandal about links between right-wing paramilitary militias and pro-government politicians, Colombia's president said she should keep her job. This week she resigned, but only after much damage to the government's image abroad.

Ms Araújo has not been accused of any wrongdoing. But her brother, a senator, was arrested on February 15th along with four other politicians. Together with her father, a former minister and provincial governor, he is alleged to have received cash from the paramilitaries and to have ordered the kidnap of a political rival.

The paramilitaries were originally formed by cattle ranchers and drug barons to fight extortion and kidnapping by left-wing guerrillas. They turned into a powerful illegal army, responsible for many atrocities. They took control of local politics, especially in the Araújo's home patch on the north coast.

Paradoxically, the revelations about the paramilitaries' political ties are a result of one of Mr Uribe's successes. He persuaded the 30,000 paramilitaries to demobilise. Some of their leaders are now testifying about their past activities. Uncovering the truth “is for the good of Colombia”, says Juan Manuel Santos, the defence minister.

But the affair comes at an awkward time for Mr Uribe's government. George Bush is due in Bogotá, the capital, next month to show support for a country that has received $4.7 billion in American aid over the past six years to fight drugs and insurgents. Colombian officials have been canvassing for nearly $4 billion more from the United States and $9 billion from Europe and Asia over the next six years to consolidate security and improve social conditions.

Patrick Leahy, who chairs the relevant Senate appropriations subcommittee, says that American taxpayers deserve assurances that Colombia's government “has severed links to these terrorist groups”. Mr Uribe denies that his government has ever had such links. Many in Washington, DC, are sceptical. “Even the Republicans are starting to lose faith in Uribe,” says Arlene Tickner of Bogotá's Los Andes University.

The new foreign minister, Fernando Araújo (no relation), escaped in December after six years in jungle camps as a hostage of the FARC guerrillas. In naming him, Mr Uribe is sending the message that his country remains in peril.

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Terrorism in India

Murder on the Friendship Express

Feb 22nd 2007 | DELHI
From The Economist print edition

EPA

Despite the latest bombing, the peace process between India and Pakistan drags on

Get article background

OUTSIDE the burns unit of Safdarjung hospital in Delhi, a family of grim-faced mourners encapsulates the particular senselessness of war on the subcontinent. They are Indians visiting their Pakistani cousin, Rana Shaukat; he is lying sobbing inside, his body horribly burned by twin bomb blasts on a Pakistan-bound train near Panipat, 80km (50 miles) outside Delhi on February 19th. It killed five of his children. They were among at least 68 victims, mostly Pakistanis. The explosions caused a firestorm in two locked carriages of the train, a recently restored service called the Friendship Express.

It could have been worse: at least two bombs failed to explode. With more than 700 people and jerrycans of kerosene and petrol aboard, the death toll might have surpassed the worst recent terrorist outrage in India, the slaughter of nearly 200 Mumbai commuters by bombs last July. The killers, though not clearly identified in either case, were probably the same: Islamist militants, based in Pakistan, dedicated to driving India from the richer part of Kashmir it controls and to spoiling a three-year peace process between the two countries. This process was briefly stalled after the blasts in Mumbai. But, on February 20th, Pakistan's foreign minister, Khurshid Kasuri, arrived in Delhi for a five-day visit. The peace process, says Commodore Uday Bhaskar, of the Institute for Defence Studies and Analyses in Delhi, is “becoming blast-proof”.

On February 21st the two countries signed an agreement to reduce the risk of an accidental nuclear war. The meetings between Mr Kasuri and his Indian counterpart, Pranab Mukherjee, gave a public face to tediously detailed “back-channel” talks on territorial disputes, including the divided region of Kashmir. The others are Sir Creek, a briny stream emptying into the Arabian Sea that should set the two countries' maritime border; and the lofty Siachen glacier, on Kashmir's eastern edge. Insiders say that with just a little mutual trust, all three disputes could be settled.

In both countries, the mood is currently for peace. That is partly born of their latest shared suffering: “Bangles from Delhi, *paan* [Betel nut] for Lahore amid the ashes”, was a typical Indian newspaper headline describing the atrocity. Pakistan has also seen more terrorism than usual in recent weeks, with suicide-bombings in Islamabad and Peshawar. They were probably organised by the same militants, or by their Islamist allies along the border with Afghanistan. Either way, Pakistan has a desperate need to end its unwinnable conflict with India, and devote itself to pacifying its own rebellious territories.

The peace process largely reflects the acceptance by General Pervez Musharraf, Pakistan's leader, of what has long been obvious: big India will never concede an inch of Kashmir, whatever littler Pakistan does. General Musharraf has therefore accepted something very close to what India demands: no exchange of territory; but with Kashmiris, on both sides, given special rights to cross the current front-line; and, as a final sop to Pakistani pride, that the two countries should jointly undertake some services on their behalf.

That General Musharraf could contemplate such an agreement is humiliating to many Pakistanis. Yet he believes that, for the benefits of peace, they will swallow this humiliation—as long as India accepts the small compromises he has suggested and provided peace comes quickly. Until that day, the general defends himself with sophistry. On February 18th he denied making any concession on Kashmir: “I have floated ideas. This is not flexibility. We have not signed any agreement.”

India, despite the conciliatory urges of its prime minister, Manmohan Singh, feels less need for peace. The insurgency it is fighting in Kashmir is likely to continue even without Pakistan's customary support. Unmagnanimous in victory, India is not inclined to make the compromises General Musharraf wants. Anonymous terrorist attacks on its people and property are likely to harden that resolve.

It would be surprising, then, if the latest example, despite the show of subcontinental solidarity, has not pushed peace further away. At least it will give the two countries the opportunity to rehearse their newest bilateral endeavour: a “joint mechanism” to combat terrorism, which Mr Singh and Mr Musharraf agreed to form after the blasts in Mumbai. Officials have been appointed to this task, but have so far done little to combat either terrorism or their utter mutual mistrust. This week Mr Kasuri and Mr Mukherjee vowed to share intelligence on the latest terrorist crime. If they did so, peace might look more possible, and the incineration of those poor passengers outside Delhi less meaningless.

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Pakistan

Musharraf does the splits

Feb 22nd 2007 | LAHORE
From The Economist print edition

He wasn't bluffing. He intends to stay on as a president in uniform

Get article background

ONE guessing game is over at last. The world now knows the solution Pakistan's president, General Pervez Musharraf, has found to an old riddle: how to stay on beyond this year both as president and as army chief, despite constitutional obstacles. On February 18th the general revealed his typically military-style answer. He will simply have the parliament re-elect him for five more years before dissolving it in September, ahead of elections his party might need to rig to win.

The government's legal experts maintain that a simple majority in parliament can change the law so he can keep both his jobs. Naturally, the opposition says all this is unconstitutional. Only a new parliament, it argues, has the right to elect a new president; and for the president to keep his uniform requires a constitutional amendment, needing a two-thirds majority.

The final arbiter of all this, the Supreme Court, is notorious for siding with the executive in times of constitutional crisis. Even so, it will not be plain sailing to 2012 for General Musharraf. For one thing, widespread anti-Americanism is damaging his standing. Businessmen appreciate annual economic growth of around 6%, in part a product of American aid given in exchange for Pakistan's help in counter-terrorism. But most Pakistanis resent General Musharraf as an American puppet.

He has fallen out with his partner in the previous general elections, in 2002, a six-party alliance of religious parties called the Muttahida Majlis-e-Amal. The MMA runs the two volatile provinces of Baluchistan and the North-West Frontier (NWFP), but parted ways with General Musharraf two years ago when, under American prodding, he sent the army to attack al-Qaeda elements “hosted” by the religious parties in the tribal borderlands. They are also angry at his reining in of the *jihad* against Indian rule in Kashmir. Indeed, the closer General Musharraf toes an American line, the more extremist groups want rid of him. There have been two assassination attempts. Bombs go off at military and police targets, gas pipelines and trains. Suicide bombers recently hit an airport and a five-star hotel. The various extremist groups have merged aims and networks so fully as to be almost indistinguishable by ideology, sect or political persuasion.

They, however, form only one-half of General Musharraf's problems. Two former prime ministers in forced exile in London are also desperate to see his back. Of the two, Nawaz Sharif's bark is louder than his bite. His Muslim League has been all but subsumed by General Musharraf's “king's party”. But after seven years in power, this has lost much of its appeal. Pundits say that it cannot, on its own, win a majority in the next elections. So even if the old parliament rubber-stamps General Musharraf's job extensions, his policies might not be safe from the new one.

The other mainstream party, the Pakistan People's Party (PPP) led by Benazir Bhutto, is still popular. Despite General Musharraf's rigging, and without Ms Bhutto to lead it at the polls, the PPP won 28% of the vote in 2002, more than any other party, though it secured under a quarter of the parliamentary seats. In a free and fair election, the chances are that the mullahs would sweep Baluchistan and the NWFP, while the PPP would pose a stiff challenge in Punjab and Sindh.

General Musharraf's options are limited. He could manipulate the next elections with the help of the spooks, risking a popular boycott and backlash. Or he could strike a deal with Ms Bhutto at the expense of the mullahs. Despite much to-ing and fro-ing, no such deal has yet emerged.

Supporters of Ms Bhutto, Mr Sharif and the mullahs are all wont to huddle together every so often and threaten to boycott the next elections, or to take to the streets. General Musharraf insists that Mr Sharif

and Ms Bhutto will be arrested and stopped from contesting the elections if they return. One guessing game has given way to another: not how he will stay on into next year, but how General Musharraf's Pakistan will unravel this year.

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Bangladesh

Another fine mess

Feb 22nd 2007 | DHAKA
From The Economist print edition

A state of prolonged emergency

Get article background

PARTY politics in Bangladesh, long a double-act as durable and acrimonious as Laurel and Hardy, has a new entrant. Muhammad Yunus, a Nobel-prize-winning microfinancier, has launched a new party, Nagorik Shakti (Citizens' Power). At the least, this may force the two main parties, Khaleda Zia's Bangladesh Nationalist Party (BNP) and the Awami League, led by Sheikh Hasina Wajed, to behave better.

The test of that, however, may not come for some time. The generals who intervened in the country's failing democracy on January 11th by forcing the president to declare a state of emergency and cancel a scheduled election, seem to be settling in for the long haul. This week they told the civilian government they back to prepare voter-identity cards for the next parliamentary election, for which no date is set, saying this would take eight to ten months.

Meanwhile the military-backed government is “cleaning up”. It has jailed at least 30 top-level criminals, mainly politicians and businessmen. Many hundreds more are wanted. A law to deal within 60 days with people charged with corruption is awaiting the president's signature. The administration has also taken many sensible steps that go far beyond its sole constitutional mandate of preparing elections. It has been trying to fix a looming power crisis (an extremely ambitious goal), to tackle the country's fiscal headaches, reform its ailing banking sector and overhaul its malfunctioning seaport, Chittagong.

Bangladeshis seem, for the time being, rather happy with emergency arrangements. But this is a dangerous state of affairs. A battle is under way in the administration, the judiciary, the army and other institutions between those who want this regime to succeed and loyalists of the BNP, which led a ruling coalition until last October. After spending most of its five-year term rigging the country's institutions to its own advantage, the BNP still has people in key positions, plenty of money and popular support across the country.

But its fortunes are waning. This week, in an extraordinary interview with *Prothom Alo,* Bangladesh's largest-circulation daily, Mrs Zia's former private secretary accused her of allowing her opportunistic coterie, including her two sons, to loot state assets on a massive scale. Mrs Zia's very future in politics already seems in jeopardy.

Mr Yunus's, on the other hand, seems bright enough to attract a barb from Sheikh Hasina, who said she saw “no difference between usurers and corrupt people”—a list to which most Bangladeshis would add “politicians”.

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Cambodia

Back from the dead

Feb 22nd 2007 | PHNOM PENH
From The Economist print edition

Cheerful news from a sad land

ALONGSIDE the barbed-wire fence of Tuol Sleng, the Khmers Rouges' former interrogation and torture centre in Cambodia's capital, air-conditioned tourist buses drop off clumps of prosperous-looking Europeans and East Asians. They shuffle past the rows of tiny cells, some of which have rusting shackles still in place. After a room of glass cabinets displaying the skulls of the Khmers Rouges' victims, they reach a tacky souvenir shop, selling T-shirts, trinkets and plastic flip-flops labelled “Pol Pot sandals”, after the regime's late tyrant.

Reuters

Tourism can be torture

In 1975-78, around 10,000 souls suffered unspeakable torments at Tuol Sleng. Nowadays, as a “genocide museum”, it is a prime attraction in the country's booming tourist industry. Until a few years ago, almost the only tourists Cambodia got were the fairly small numbers taking day-trips to the massive Angkor Wat temple complex in the north. Now visitors pour in to the capital, to the seaside resort of Sihanoukville and even, now that the roads are being improved, to the little-explored countryside. Sihanoukville's airport reopened last month to its first scheduled flights since the 1980s and the country's moribund railways are to be restored.

In 1993, as United Nations-sponsored elections signalled the end of the civil war that followed the Khmer Rouge regime's collapse, Cambodia got only 154,000 foreign visitors. Last year there were 1.7m, up 20% on the previous year, and they spent some $1.4 billion, or around twice the government's entire tax revenues. A fair chunk of this money is trickling down on to the bustling streets of Phnom Penh, whose tuk-tuk drivers are doubling their basic fare (for rich-looking foreigners) to $2.

Everything from construction to financial services is booming too. Cambodia's clothing factories continue to defy predictions that competition from China would kill them. Most important, agriculture, which employs two-thirds of the country's workers, is powering ahead, encouraged by strong export demand from Cambodia's also-booming big neighbour, Vietnam.

When a bumper harvest boosted Cambodia's growth rate to 13.5% in 2005, this was seen as an aberration caused by freak weather rather than any lasting improvement in productivity. However, a report from the IMF this week shows that farm output has continued rising, and last year's overall economic growth was far better than expected, at 10.5%.

The report forecasts a continuing boom this year, with perhaps 9% growth. Better seeds and wider use of

fertilisers are helping farmers reap more from their rice paddies, says John Nelmes, the IMF's representative in Phnom Penh. They are also successfully diversifying into other cash crops. “This is the type of growth that brings immediate benefit to the poor,” he says. Last year the Fund forgave the $82m the country owed it, some of which will be redirected towards improved irrigation.

Cambodia is slowly but, it seems, surely dragging itself up from a very low base. Perhaps a quarter of its entire population died under the Pol Pot regime, including most of its educated people. The ineffectiveness of its government is a result of the dire shortage of capable people as well as of endemic corruption. Education, health services and basic sanitation are still lacking in rural provinces. Child labour and child prostitution are widespread. But fast economic growth is spreading cheer across the country, from the trendy bistros of Phnom Penh's riverfront right out to the impoverished countryside. And things could get brighter still: substantial oil and gas reserves have recently been found off Cambodia's coasts. The huge potential revenues from these could sustain the boom for years to come—so long as they are spent wisely.

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American forces in Japan

Overpaid to move over here

Feb 22nd 2007 | IWAKUNI
From The Economist print edition

The local politics of "realigning" America's bases

FRUSTRATED with local officials, who have been playing politics over the relocation of American forces around Japan, the government in Tokyo has decided to give the carrot one last chance. If it is not nibbled, out will come the big stick. Legislation is being introduced to provide ¥100 billion ($840m) of special subsidies for local municipalities that accept more American troops and aircraft. But woe betide local politicians who resist.

Last May Japan and America agreed on far-reaching changes aimed at building a more nimble and effective strike force in the region, partly in response to the threat of a nuclear-armed North Korea. This "realignment" was one item on the agenda of Dick Cheney, the American vice-president, who visited Japan this week. One important aim is to reduce America's enormous presence in Okinawa, home to half its 48,000 troops in Japan. The Marine Corps' Futenma air station is to be closed and the land handed back to the nearby city of Ginowan. Some 8,000 marines and their families will be moved to Guam, where the Japanese government will foot two-thirds of the bill for housing them.

Ever since 1995, when a 12-year-old schoolgirl was abducted and brutally raped by three American servicemen, the Futenma base has been a flashpoint for opposition to America's military presence. With tempers running high, President Clinton offered to hand the base back to the local authorities as soon as an alternative could be found. That alternative is a V-shaped pair of runways to be built on largely reclaimed land next to an existing American base in the remote, and even poorer, northern part of Okinawa.

However, scenting the chance for an even huger handout from Tokyo, Yoshikazu Shimabukuro, the newly elected mayor of the nearby city of Nago, demanded that the plan be rethought from scratch. He may have overplayed his hand. Blaming the lack of co-operation, defence ministry officials made it clear last week that the funds for Nago—thought to be a big chunk of the ¥5.1 billion of "realignment subsidies" in this coming year's budget—will now be diverted to other uses. That has set off alarm bells in other city halls.

Nowhere more so than in Iwakuni, near Hiroshima, where the marines share a large coastal base with Japan's Maritime Self-Defence Force. Iwakuni is America's most important base in north-east Asia, being its closest airfield to North Korea and within easy reach of other potential hotspots, such as Taiwan. As part of the realignment plan, some 70 American aircraft and their crews are to be shifted to Iwakuni from elsewhere in Japan.

Nothing can happen at Iwakuni, however, before the completion of a new runway in 2008. Constructing the $2.5 billion runway on reclaimed land in waters off the existing base has already poured a good deal of money into the area. Even so, fearing increased crime and congestion, city officials have fiercely resisted the expansion. Under pressure from the Americans to complete the project as quickly as possible, the defence ministry has now decided to start banging heads. In the new budget for the fiscal year starting this April, the ministry pointedly left out any mention of subsidies for Iwakuni.

That was enough to get Katsusuke Ihara, the mayor of Iwakuni, on the train to Tokyo in a bid to reopen talks about realignment, and revive the suspended subsidies for his city's fancy new municipal-government building. But Fumio Kyuma, the defence minister, acted tough, telling his visitor that to provide the subsidies as things stand would be against the law. That has left Nago's Mr Shimabukuro with a lot to chew on as well.

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Tigers

What immortal hand or eye?

Feb 22nd 2007 | BEIJING
From The Economist print edition

The controversial ancestry of the South China tiger

FEW peoples are as proud of their uniqueness as are the Chinese. Many feel the same way about one of their national emblems: the South China tiger. So two Americans who have questioned its pedigree have created quite a stir.

In 2004 Stephen O'Brien, head of genetics at the National Cancer Institute in Maryland, published the results of a 20-year study into the species. His findings concluded that of the five beasts he sampled, labelled in the Chinese zoos where they were kept as South China tigers, only two were of "unique lineage". Three were no different genetically from the Indochinese tiger, a separate sub-species endemic to Vietnam, Myanmar, Cambodia, Thailand and Laos.

Reuters

Incest is best

His study has great bearing on the animal's future. Hunted to the brink of extinction during Mao Zedong's "anti-pest" campaigns, the South China tiger is the rarest of five tiger sub-species, and there have been no confirmed sightings in the wild for more than 30 years. Many experts think the 68 now kept in Chinese zoos and research centres are the only ones left. These survivors are all the progeny of just two males and four females, and display the lowered fertility and above-average infant mortality that goes with inbreeding.

Mr O'Brien's findings are good news for Ronald Tilson, a conservationist, who advises a national programme to reintroduce the beast into the wild. He recommends setting up two massive reserves in the provinces of Hunan and Guangdong. He now thinks it will be easier to find "free-ranging, healthy, reproducing tigers" to fill them, because there should be no objection to introducing Indochinese specimens into the incest-ridden breeding stock.

Mr Tilson first made himself unpopular with his hosts in 2001. After leading officers from the State Forestry Administration (SFA) on a census of wild South China tigers, he declared that none was left. Many Chinese will take no less kindly to being told the tiger is an undistinguished mongrel, and that miscegenation is the way forward.

The SFA's Wang Weisheng, for example, angrily denies that the South China tiger is extinct in the wild. He cites the example of the Père David's deer. At one time, fewer than 20 of this Chinese ungulate survived—all in the grounds of an English stately home. After a successful breeding programme, thousands now live in Chinese reserves.

Yet neither Mr Wang nor any other Chinese official denies that the South China tiger urgently needs new blood. At a conference last November, Wang Xingjin, of Guangzhou Zoo's South China Tiger Research Programme, admitted the South China tiger was "very probably" extinct in the wild and will certainly disappear, "unless we can find a wild tiger to enter the breeding pool."

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Ethiopia

On a dilemma in the Horn

Feb 22nd 2007 | ADDIS ABABA
From The Economist print edition

Panos

Should the West go on helping a repressive Ethiopia?

THE second most populous country in Africa and one of the poorest, Ethiopia is a test case for the West in its efforts to eradicate extreme poverty on the continent. But its government's undemocratic leanings have presented donor countries with a dilemma. Should they continue to funnel their taxpayers' money to a country that routinely jails and tortures its critics or should they turn off the tap and thereby hurt the blameless poor?

Most donors are keeping up or even increasing their giving. Britain, with qualms, is upping its aid from $180m last year to $260m this year. Some donors have harmonised and even pooled their support. Many have signed up to schemes to promote transparency and hold the government to account. Whether the nastier bits of Ethiopia's government will co-operate fully is moot.

So the donors—Western governments and charities—think that on balance they should continue to improve farming, health care, education and access to water in the rural areas where 85% of Ethiopians live. There are signs that the government's ambitious poverty-reduction strategy is working. Infant mortality is down, school attendance and literacy are up, though only 40% of Ethiopians can read and write.

Farming practice may be improving. In Ethiopia's wet highlands farmers may try to diversify crops. Ethiopia hopes to export hydroelectricity to neighbouring Djibouti and Sudan. Some agronomists think that, with enough investment, Ethiopia will be able to feed itself. That may be optimistic. The population of 75m-plus is growing by about 2m a year. Food prices in Addis Ababa, the capital, rose last year by 27%.

In any event, Meles Zenawi's government is finding it hard to run the show. Some 80% of the people in Addis Ababa probably back opposition parties. In response, the government has become harsher, muzzling free speech and forcing independent newspapers to close. Many journalists are in jail on trumped-up charges. Dissidents have been disappearing, along with critical websites. Telephones are often tapped. For more than a year, text messaging on the country's small number of mobile phones has been hampered by “technical difficulties”.

The government keeps up a hum of fear with attacks on opposition supporters. Teachers are a favourite target. Some have been beaten so badly in detention they could not stand up in court. Even schoolchildren have faced the authorities' wrath. In Ambo, west of the capital, some 14 of them in a secondary school were detained; some were allegedly tortured. The usual charges, if brought at all, are

sabotage or treason. Suspects are often “found” to have links with familiar bogeymen: neighbouring hostile Eritrea; the Oromo Liberation Front, a movement in the centre and south; or, in the heartland of the once-ruling Amhara around Addis Ababa, “terrorist groups” whose existence is fuzzy.

The opposition's lot may be worsening. Dissidents say as many as 250 supporters were rounded up on terrorist charges after the African Union summit last month; some have disappeared. The opposition's main leaders have been in prison for over a year. Torture, especially against lesser-known prisoners, is common. If rural areas are taken into account, extrajudicial killings may run into thousands. But the opposition is divided, often has regional rather than national allegiances, and tends to take its cue from radicals in exile.

Moreover, despite help from abroad, the economy is struggling. Exports are worth $1 billion against imports of $5 billion. Sales of coffee and flowers to the West have increased but not enough. Mr Zenawi has applied for membership in the World Trade Organisation. He has also asked China for loans—some say for $3.5 billion.

But most of all he is banking on keeping up his friendship with the EU and the United States, whose administration was delighted by the Ethiopian armed forces' recent success in invading neighbouring Somalia, capturing its capital, Mogadishu, and smashing the Somali Islamists who had taken over there. Still, there are conflicting attitudes to Ethiopia in Washington. Congress has lambasted Mr Zenawi's human-rights record and demanded cuts in aid. The Pentagon, on the other hand, is dead keen to boost his armed forces.

In September, hundreds of thousands of Ethiopians from their vast and far-flung diaspora are expected to visit their homeland to celebrate the coming of the third Christian millennium, according to their ancient church's calendar. Some hope Mr Zenawi, in a gesture of conciliation, will free some of his opponents from jail before then. But do not bet on it. Mr Zenawi has got used to wielding an iron fist.

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Eritrea

Still in the regional game?

Feb 22nd 2007 | ASMARA
From The Economist print edition

A small country that can help or hinder progress towards peace in the Horn

WHEN Ethiopia invaded Somalia at the same time as Somalia's Islamists were getting arms from (among others) Eritrea, there were fears that the war in the Horn of Africa might spread. Eritrea has long been at daggers drawn with Ethiopia, and fought a bitter war with it between 1998 and 2000 over a disputed border. But so far the latest war in the region has been contained. This week the UN Security Council authorised the African Union to send peacekeepers to Somalia for at least six months. Ethiopia, meanwhile, has emerged as the Horn's top dog.

A slap in the face of Eritrea, then? It has long given aid to a variety of Ethiopian rebels in the hope that Meles Zenawi, Ethiopia's leader, would fall. Eritrea's policy of helping Somalia is part of the same game. But the government in Asmara, Eritrea's capital, was also wary of getting sucked too far in. Its economy is in a shambles. It could not afford another war.

In November a UN report said that Eritrea had almost 2,000 soldiers inside Somalia, a claim strongly denied in Asmara. More likely, Eritrea's government was acting as a middleman and conduit for Arabs and others wanting to help Somalia's Islamists, who took over most of the south and central parts of Somalia last summer. In return, Eritrea probably got a lot of Arab cash and petrol to keep its economy afloat.

In any event, Eritrea must be careful. Half its people are Muslim, half Christian. Its government is wary of fostering extremists elsewhere in the region, since they might decide to help Eritrea's own extremists to try taking over Eritrea itself.

In the weeks after Ethiopia invaded Somalia, Eritrea's government-orchestrated editorials shifted a little from abusing the Ethiopians to castigating the United States. Eritrea's relations with America have worsened over the past few years, especially since it and the West seemed to acquiesce in Ethiopia's rejection of an independent arbiter to mark the disputed Eritrean-Ethiopian border. Instead, Eritrea has cosied up to anti-American countries, including Iran and Libya.

While vainly helping Somalia's Islamists, Eritrea has shown it can also help make peace if it wants to. It has mediated between Sudan's government and Sudanese rebels on its border with Eritrea. And it is trying to promote peace in Sudan's bloody western region, Darfur. Despite its recent setback in Somalia, it still wants to assert its claim to be a regional player.

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Senegal

Cherish that democracy

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From The Economist print edition

The successful incumbent should guard against a concentration of power

OPINION polls have been banned in the presidential election run-up but most people in Dakar, the Senegalese capital, are assuming that the 80-year-old incumbent, Abdoulaye Wade, who spent almost three decades in opposition before breaking the mould in 2000, will be returned to office on February 25th. Most of his opponents have been tied up in internal wrangles and flaky alliances. So his ruling Senegalese Democratic Party (PDS) has been sitting pretty.

When Mr Wade swept to power seven years ago with the battle cry of *Sopi* ("change" in Senegal's main language, Wolof), he inherited a country that had been run by the Socialist Party for 40 years. It had become corrupt, its civil service bloated, its economy sclerotic. The president can claim, with some justification, that he has changed things for the better.

New offices, roads and tunnels are being built apace; indeed, Dakar has become notorious for traffic jams. In the past four years, the economy has been growing briskly, at rates of between 5% and 8%, while per capita GDP has been edging towards $700 a year, close to the level achieved by the region's powerhouse, Côte d'Ivoire, before it fell into civil war.

But there have been failures too. A bungled privatisation has messed up commercial farming. Last year's badly handled closure of Senegal's biggest chemical plant has contributed to a reduction in industrial output. Unemployment is said to be 48%. Boatloads of desperate Senegalese men still arriving illegally in Europe testify to the scarcity of decent jobs.

And there are worries about democracy. Mr Wade's governing style is highly personal. "He decides alone, he rules alone, he acts alone," says a seasoned commentator in Dakar. In a controversial book by another well-known analyst, Abdou Latif Coulibaly, the president emerges as a powerful intellect, intense and complex, but loth to listen to advice and prone to outbursts of temper if contradicted.

As a result, key decisions tend to be taken off the cuff and outside the institutions of government. This may be slowing big construction projects, since foreign donors and investors are reluctant to pour in the cash without more openness. People are also becoming queasy about the rise of Mr Wade's son Karim, a rich businessman and influential adviser. Some think a dynasty is in the offing.

Many Senegalese are also upset by what they see as the president's bringing religion into politics. Senegal has a special brand of Islam, underpinned by a system of respected brotherhoods that have been tolerant yet economically powerful. Until Mr Wade became president, they had kept out of politics. By seeking to involve them on his side, the president may—so his critics fear—have tainted them.

The worst example of institutional weakness, argues Mr Coulibaly, was the sinking of a ferry in 2002, when more than 800 people perished. This, he says, could have been prevented if a well-connected business lobby had not illegally pushed the ship back into service when it still needed vital repairs. In sum, the president, if re-elected, should heed the adage that power tends to corrupt.

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South Africa

Careful with those coughs

Feb 22nd 2007
From The Economist print edition

A deadly strain of tuberculosis may be more widespread than thought

Get article background

Reuters

Holding the fort in Tugela Ferry

NOT long after Tony Moll started prescribing anti-retroviral drugs to AIDS patients, he noticed a bizarre pattern in his records. For 15 years, as a hospital doctor in the rural town of Tugela Ferry, in the heart of South Africa's KwaZulu-Natal province, he had watched locals with extinguished immune systems die from infections like tuberculosis, unable to give them medicine that worked. In the early months of 2005 a good number of his patients' lives had been reinvigorated by the drugs. Yet a small group died from TB anyway, even though their white blood cells appeared to be back in business.

This was the first hint that something was amiss. Dr Moll had an extensive problem on his hands, it turned out, called extensively drug-resistant tuberculosis, or XDR-TB. It is sprouting roots in neglected spots on every continent. Tugela Ferry's bug, however, takes on average an unprecedented 25 days after diagnosis to kill, making it the deadliest of all strains for people with AIDS. By September last year, 52 of 53 patients infected with the bug had died, so the World Health Organisation decided it was time to write a worried press release and call a meeting in the country.

By last week, Tugela Ferry's hospital of 355 beds had clocked up 222 XDR-TB infections. The bug has been reported in every South African province. Furthermore, two very recent cases have shown that the bacterium can infect HIV-negative people as well, so it may be getting more virulent as it evolves.

At the root of the problem lies a government that has played a poor hand badly. South Africa faced the world's largest TB challenge even before resistant strains emerged. Jerome Singh at the University of KwaZulu-Natal says many patients with TB that is resistant to a few drugs opt to stay at home instead of getting treated at hospitals. There, nurses cannot nag them against using public transport or about completing their course of antibiotics, so they mix widely and unwittingly encourage their infections to evolve increasingly impervious forms. That choice, he says, rests on a government policy that withholds welfare benefits for the duration of a hospital stay at the state's expense.

Some think South Africa should consider forcibly confining unco-operative patients carrying the nastiest strains, however much that would flout individual liberty. But in out-of-the-way towns like Tugela Ferry, it might put HIV-positive people with persistent coughs off seeking treatment at all.

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Israel and Palestine

Banking on the Saudis

Feb 22nd 2007 | JERUSALEM
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With Israeli-Palestinian talks back on ice, the Saudis offer a glimpse of hope

THIS week the United States and its partners in the "Quartet" (Russia, the European Union and the UN) reiterated that they will not deal with a new Palestinian unity government, which the rival Fatah and Hamas factions agreed earlier this month to form, any more than they dealt with the previous Hamas-run one, unless it accepts their three conditions (to recognise Israel, renounce violence and accept previous Israeli-Palestinian accords), which it almost certainly will not do. America and Israel said they would keep up their contacts with the Palestinian president, Fatah's Mahmoud Abbas. But despite talk of giving him a "political horizon", they said nothing about what that might mean; certainly not an outline of future peace talks, as Mr Abbas had hoped.

So was the Fatah-Hamas deal in vain? And why did Condoleezza Rice, the American secretary of state, fly all the way to Jerusalem to see Mr Abbas and Ehud Olmert, the Israeli prime minister, and on to Jordan to see America's other Arab allies, to tell them something she could have fitted into an SMS text message?

A Hamas-Fatah government should at least end the plague of factional violence. And it might at last knuckle down to negotiate a swap of Palestinian prisoners in Israel for Gilad Shalit, a captured Israeli soldier in Gaza.

Ms Rice, meanwhile, may simply have needed to show her face. An Israeli who met her in Jerusalem said she wanted to maintain the Quartet's unity: some European countries may want to break ranks with the boycott, which has been impoverishing Palestinians and destroying their statelet for nearly a year while barely altering Hamas's stance.

But in any case America is holding back from serious involvement while it sees what else Saudi Arabia can do. King Abdullah and his energetic security adviser, Prince Bandar bin Sultan, a former long-time Washington ambassador, may try to stick another feather in their caps at next month's Arab League summit. They want to revive and perhaps refine the Arab League's 2002 proposal for all Arab states to normalise relations with Israel if Israel withdraws from all the territories it occupied in 1967, both Palestinian and Syrian.

In Jordan Ms Rice may have had a preview of what may be on offer. Perhaps the Saudis will present firmer details of what Israel could expect from normalisation—rather like the "political horizon" Mr Abbas hoped to be offered. Israel's housing minister said recently that Israel should start talks about it with the Arab world. But Mr Olmert, whose government has been rocked by scandals and is bracing itself for the results of an inquiry into last summer's war in Lebanon, will probably turn a deaf ear; his main concern is just surviving.

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Iran

Defying the United Nations

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Iran continues to dig in its nuclear toes. What next?

DESPITE a UN Security Council resolution that gave Iran until February 21st to stop enriching uranium or face a wider range of economic sanctions, the Islamic Republic blithely ignored the international body and declared, in its president's words, that it would “continue our work to achieve our right [to nuclear technology] in the shortest possible time”. The earliest it could produce a bomb, in the estimates of most Western experts, is three years.

As ever, a top Iranian negotiator, Ali Larijani, dangled the prospect of last-minute deals and said Iran would never use enriched uranium to make a bomb. But the clock is ticking. A more punitive set of sanctions may be imposed in an effort to isolate Iran. Other trade and banking embargoes being pressed by America outside the Security Council are starting to bite. The 35-country board of the International Atomic Energy Agency, the UN's nuclear watchdog, is to meet in early March. The Security Council must then decide on its next step.

Russia's position will be particularly closely watched. It has delayed the delivery of fuel to feed the nuclear reactor it has been building at Bushehr, which has been exempted from sanctions so far. Russia reluctantly voted for the resolution in December that gave Iran 60 days to stop uranium enrichment, as well as plutonium work, an alternative route to bomb-making. Russia's co-operation with the other five countries leading the diplomacy with Iran (the permanent members of the UN Security Council plus Germany) will be vital if Iran is to be squeezed, belatedly, into compliance.

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Italy

Pasta and fries

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AP

Italian anti-Americanism costs Romano Prodi his job

THE parliamentary tornado that ripped through Romano Prodi's centre-left government on February 21st, prompting its leader to resign, showed how dangerous it can be for a European government to be seen to be backing the Bush administration. The same day Tony Blair, George Bush's closest ally, announced the departure of some British troops from Iraq, Italy's prime minister was humiliated in a crucial parliamentary vote, centring on Italy's involvement in Afghanistan.

As President Giorgio Napolitano began consulting party representatives on a possible replacement for the prime minister, the cause of Mr Prodi's troubles looked more significant than their immediate result. Rather than forcing Italy's long-suffering voters back to the polls (this was the 61st government since 1945) the president was expected to try for a cabinet headed by someone more widely acceptable in parliament, or even for a remodelled Prodi administration. The outgoing coalition's core parties quickly said they would support Mr Prodi again.

Mr Prodi actually won the vote in Italy's Senate by 158 votes to 136 with 24 abstentions. But abstentions count as votes against, so the formal result was a two-vote defeat. It was not, technically, a confidence vote, so Mr Prodi did not need to step down. But his foreign minister, Massimo D'Alema, had just said that defeat would mean it was time for “everyone to go home”. Exultant representatives of the centre-right, which is led by the media proprietor and former prime minister, Silvio Berlusconi, pounced on his undertaking. Holding aloft a copy of a newspaper headlining the pledge, Mr Berlusconi's chief whip in the upper house cried: “There is no Prodi government any more. The Prodi government has fallen in this chamber.” When news reached the lower house, the Chamber of Deputies, scuffles broke out between government and opposition. Over a hundred people gathered outside Mr Prodi's office chanting “Resign, resign”.

Behind the defeat lay profound divisions over foreign policy within Mr Prodi's government. In recent weeks two largely separate issues have become perilously entwined. One is Italy's contribution to Afghanistan's International Security Assistance Force (ISAF). Since Mr Prodi pulled Italian forces out of Iraq last year, the left-most members of his sprawling, nine-party coalition, which includes Greens, Christian centrists, ex-communists and radical leftists, have increasingly focused their attention on ISAF. Though the mission has a United Nations mandate, it is NATO-run, jarring the Italian left's strong pacifist and anti-American sensibilities. Three ministers walked out of the cabinet rather than sign off extra funding for the Afghan force, which has yet to be endorsed by parliament.

Amid growing concern about Italy's wobbly commitment to ISAF, the ambassadors of six other participants published an open letter, appealing for continued support. That may have backfired: Mr D'Alema, a staunch backer of ISAF, angrily dismissed the move as interference by outsiders in Italy's democracy. The Chamber of Deputies, where the government has a bigger majority, was due to start debating the funding on February 26th; it must go to the Senate by mid-March. That is why a reckoning in parliament on the government's foreign policy had become urgently needed.

The day before the Senate vote, Mr Prodi sealed a deal with the majority of the doubters in his camp by promising to use a meeting on Afghanistan in Rome, due by May, to prepare a future peace conference (to which some on the left would like to invite the Taliban). But this proved too little for two far-left senators, who withheld their votes.

They and other radicals were equally exercised by the government's readiness to agree to the expansion of an American military base at Vicenza in northern Italy. On February 17th, some 70,000 people—including leading figures in the governing coalition—marched in protest at the plan. Mr Prodi swiftly declared that he did not intend changing a 50 year-old defence policy, based on the three pillars of the European Union, the UN and NATO.

Fine words. But barely a week later, that once-uncontroversial approach to Italy's alliances had ended in disaster. The implications go beyond foreign policy. The outgoing government had an urgent domestic reform agenda. A crisis like this, even if it leads to a remodelled Prodi government, raises big questions once more over the ability of a humbled and disconcerted centre-left to push through the painful changes that Italy needs.

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Russia

The hollowing out of politics

Feb 22nd 2007 | MOSCOW
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The installation of a warlord as Chechnya's president reflects a wider trend as Russia braces for next year's presidential election

Alex Williamson

Get article background

ALU ALKHANOV is unusual among ex-presidents of Chechnya, be they secessionists or Kremlin puppets: he is alive. Last week he was peacefully relieved of his responsibilities by Vladimir Putin, who appointed as acting president the 30-year-old Ramzan Kadyrov, a volatile former rebel warlord who is the son of another (deceased) Chechen leader.

Chechnya's fate and Mr Putin's have long been intertwined. He rose to power on the back of the Chechen war launched in 1999. Mr Kadyrov's elevation (to be rubber-stamped by the Chechen parliament) is designed to ensure Chechnya's stability in the nervous run-up to Mr Putin's putative departure from office in 2008. It formalises the de facto power that, with his feared militia, Mr Kadyrov has long wielded anyway. But it also reflects, as Chechnya tends to, the wider political situation in Russia. It is part of what Vladimir Ryzhkov, an independent member of the lower house of parliament, the Duma, describes as a political *zachistka* (purge): a word mainly used to describe bloody Russian raids on Chechen villages.

The raids on Russia's constitution are incremental but no less insidious. The 5% threshold to win seats in the Duma, already set high enough to keep out all the liberal parties at the 2003 election, will be raised to 7% for the parliamentary poll later this year. Parties are barred from forming coalitions to get over it. Candidates may come only from party lists; in the previous system half were directly elected by district (that enabled Mr Ryzhkov, for example, to survive). Candidates can be debarred for “extremism”; that includes slandering a public official. Minimum turnout rules have also been scrapped, as has the option of voting “against all”. So boycotts and protest votes can no longer be used to register dissent.

Dirty tricks are common. Halls booked for opposition party meetings become suddenly unavailable. Rallies and protest marches are easily banned, and smothered by riot police when they are not.

“All our actions”, Mr Putin said recently in Munich, “are designed to strengthen a multi-party system in Russia.” Quite so. Along with United Russia, the blindly loyal majority block, the next Duma will most likely have a Communist rump and the Liberal Democrats: a largely comical faux-nationalist outfit also loyal to the Kremlin. The main “opposition” party may be a new one called A Just Russia, created by the Kremlin last year to appeal to left-wing and nationalist voters. The result, says Grigory Yavlinsky of Yabloko, a fading liberal party, is the “illusion of competition”, rather like that between rival boyars in

tsarist times. Mr Ryzhkov, whose Republican Party is also stymied by election rules, calls it the “Dresden system”, a reference to East Germany's bogus multiparty system, which Mr Putin doubtless recalls from his spying days in Dresden.

There are other obstacles for the outsiders. After the example made of Mikhail Khodorkovsky, a former oil tycoon now facing fresh criminal charges from his Siberian prison, businessmen are disinclined to fund Mr Putin's critics. Meanwhile, the Kremlin's grip on the media ensures such voices are rarely heard.

Some small-scale independence survives. Take *Novoye Vremya* (The New Times) a new magazine whose boss was sacked from a big daily paper for his too-frank coverage of the Beslan school siege in 2004. Yevgenia Albats, its political editor, blames the tameness of much of the print media on self-censorship and ambition. “If you want to be part of the establishment,” she says “you cannot write the truth.” Outside Moscow journalists face graver perils: this week, in the North Caucasus town of Vladikavkaz, the office of IWPR, a brave London-based journalism network, was raided by the police. Yet there are signs of life too: Victor Fedofenko quit his paper in the Siberian town of Khanty-Mansiysk, after its owner vetoed an article on embezzlement. He and his colleagues started a new one, with a picture of Che Guevara on its first front page, because, says Mr Fedofenko, “We associate him with freedom.”

But television—from which most Russians get their news—is another story, as even Kremlin officials admit. Political news is dominated by flattering coverage of Mr Putin's day. All the main channels are in effect controlled by the Kremlin. The general trend, says Masha Lipman of the Carnegie Moscow Centre, is to safe, non-political subjects.

Mr Putin and his aides argue that similar approaches can be found in Western countries. But cumulatively they represent a concerted erosion of democratic freedoms. Some measures, such as onerous new registration rules for campaigning groups, have not yet resulted in the draconian clampdowns some predicted. But they create anxiety and instil obedience simply by existing. So does the re-emergence of Soviet-style checkups on those citizens having too close contact with foreigners and other undesirables.

The mystery is why, popular as he is, Mr Putin bothers with all these superfluous instruments of control. Part of the answer is: because he can. But another part is that his worry is probably not defeat in stage-managed elections, but rather unrest on the streets (hence the creation of a pro-Kremlin youth movement). That, plus infighting or palace coups inside the Kremlin, where Russia's real political competition takes place.

The need to maintain a balance between rival Kremlin clans seems to explain Mr Putin's other main personnel move last week, which was to shift Sergei Ivanov from the defence ministry to be a first deputy prime minister. That rank is also held by Dmitry Medvedev, who like Mr Ivanov is considered a frontrunner to succeed Mr Putin in 2008. That may free Mr Ivanov from the tarnish of perpetual scandals over brutality in the army (one recent allegation is that soldiers in St Petersburg were forced into prostitution). Some now speculate that the 2008 presidential contest will be between two approved candidates. But the main benefit of the change is to Mr Putin, who has reasserted his grip on the succession process and shored up his power.

That is another way in which Chechnya reflects, in extreme form, the general situation. Under Mr Kadyrov in Chechnya, as under Mr Putin in all Russia, economic improvements have come at a cost of corruption, opacity and lawlessness. Both regimes rest on highly personalised rule that looks secure but may yet prove unstable.

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Swedish security

Back on the block

Feb 22nd 2007 | COPENHAGEN
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Sweden's growing worries about Russia fuel a love-in with Norway

WHEN the cold war ended, Sweden felt able to turn a furtive friendship with its fellow neutral Finland into a close economic, political and security one. Now it wants also to cosy up to its western neighbour and NATO member, Norway. Again, the motivation is Russia—but fear, not rapprochement, is the spur.

The Swedes' immediate worry is a planned Russian-German gas pipeline on the Baltic seabed. That is littered with dumped chemical weapons and other munitions dating from the second world war, and home to sensitive submarine defences built during the cold war. A planned pumping station (see map) close to the Swedish shore has infuriated the country's defence establishment, which fears it will be used for Russian electronic espionage or other mischief-making. Such concerns give Sweden no legal basis for blocking the pipeline, but it is trying to delay it on environmental grounds.

A combative radio interview by the Russian ambassador to Sweden, Alexander Kadakin, has failed to allay fears. He repeatedly described critics of the pipeline as “idiots”, arguing: “why should we need [another] spy station when we already have the real-time capability to read the number plates of every car in Stockholm?”

Last week Mats Engman, head of Sweden's influential MUST military intelligence and security service, publicly gave warning of the “Russian bear's...greater self-confidence and increased freedom of action.” In the same week another top military thinker, Stefan Gustafsson, said: “the strategic map has changed. We must now analyse what resources are required at home if tension in the north were to grow.” He noted that Russia's economic prosperity was financing a sharp rise in defence spending.

Sweden and Norway are the military heavyweights of Scandinavia (Finland maintains a well-trained army with a stellar record, but has only a vestigial navy and air force). General Håken Syrén, commander of the Swedish armed forces, said recently that “Swedish and Norwegian security and defence interests are running closer than ever...and often shared.” Sweden already shares its radar surveillance data closely with Finland and is discussing other military monitoring projects. It now hopes to match these by similar co-operation with Norway.

However much diplomats may wince, there is no disguising that all this aimed at only one country: Russia. The hottest issue is energy. Norway hopes that a newly hawkish Sweden will be supportive in its long-running dispute with Russia over the two countries' northern sea border (see map). At stake are the “High North's” lucrative, and still largely unexploited, oil and gas reserves.

A big sign of intensified co-operation would be if Norway chose to upgrade its air force with the Gripen JAS-39 fighter, made by Sweden's Saab. A Swedish television investigation this week claimed to have unearthed evidence of bribes of 1 billion kronor ($142m) paid to support the sale of 24 Gripen jets to the Czech Republic. A second programme next week will make similar allegations about sales in Norway. That may hold things up a bit.

Unlearning the trusting habits of the past decade will be hard: Sweden's security establishment was run down in years when trade promotion and haggling in Brussels outweighed Russia-watching. Hawks are cheered by the foreign minister, Carl Bildt, a tough-minded and eloquent figure who as prime minister from 1991 to 1994 threw Sweden's weight behind the freedom of the Baltic states.

All this is uncomfortable for Finland, forced by geography into a more cautious stance towards Russia. Finns have never forgotten that they learned of Mr Bildt's decision to apply for Swedish membership of the European Union only when they read it in the newspapers. Some wonder if they might get the same nasty surprise about Sweden and NATO.

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Polish spies

Of questionable intelligence

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Poland leaks spooky secrets but fails to prove a conspiracy

PUBLISHING the names of serving spies is a huge taboo in the intelligence world. It endangers not only them, but anyone they have met. You might do it to your enemies on occasion, but never to your own side.

Yet Poland's official report on the recently disbanded WSI (military intelligence service), has named dozens of current and former agents including some in highly sensitive places such as Afghanistan. That has provoked derision and alarm in equal measure, for at first sight the gains seem elusive and the costs high. Serving diplomats, their cover blown, have hurried home. They include the ambassadors to Austria, China, Kuwait and Turkey. At least ten of the names, including the military attaché in Moscow, are fiercely contested.

The aim was to highlight the WSI's role in the cosy business and political arrangements that took root in Poland following the collapse of communism. The report does raise disturbing questions about both Russian penetration of the WSI, and its involvement—perhaps with Kremlin help—in the energy industry among others. It strongly suggests a past failure of political oversight. But the seemingly muddled and inconclusive material published so far falls far short of the “atom bomb”, proving conspiracy and subversion, promised by its author, Antoni Macierewicz. It is puzzling too that some scandals of past years are treated so sketchily.

Mr Macierewicz is undaunted, as are his sponsors, Lech and Jaroslaw Kaczynski, the twins who are respectively Poland's president and prime minister. “This was one of our most important goals and it was worth it,” said the prime minister. Government defenders say the criticism comes from those with a vested interest in maintaining the old order. No real secrets have been leaked, as the Russians already knew the WSI inside out.

Mr Macierewicz, who—remarkably for a political appointee—runs the new military counter-intelligence service, insists the best is yet to come. Many leads remain to be chased; missing and destroyed documents have slowed things down. Maybe so—though it is hard to argue that Polish political life will benefit from yet more months of leaks, innuendo and suspicion.

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Biofuels

Burned by the sun

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From The Economist print edition

Can biofuels save Europe, or the planet?

WHEN all else fails, agree on biofuels. That has been the reassuring mantra of European Union energy policy, plagued by disagreements on unbundling over-mighty power firms, haggles over carbon trading and worries about dependence on Russian gas. But a forthcoming report from the EU's own environment agency argues that the beloved biofuels—ethanol, rapeseed biodiesel and the like—have big drawbacks.

Last week EU energy ministers endorsed a European Commission proposal that biofuels should make up a mandatory 10% of the EU's fuel consumption by 2020; the current voluntary target is 5.75% by 2012. European heads of government are likely to back that deal at a summit next month in Germany.

Despite this apparent enthusiasm, most EU members will struggle to meet even the existing target. Only Sweden and Germany fulfilled an earlier goal of 2% renewable-fuel use by 2005. The main problem is that biofuels are expensive. According to KBC Peel Hunt, a stockbroking firm in London, diesel made from rapeseed costs roughly €0.3 ($0.39) a litre more than the ordinary sort, despite benefiting from various agricultural subsidies. British biofuel firms are struggling to sell their output even with a tax rebate of 20p ($0.39) per litre. The government, naturally, is reluctant to erode its lucrative fuel-tax revenues by increasing the rebate.

Several countries are trying to pass on the cost of adopting biofuels to motorists. Germany, the most biofuelled nation in Europe, has replaced a tax break with a straightforward legal obligation for refiners to blend a certain proportion of biofuels into their wares. From next year, Britain will do the same, and fine firms 15p a litre if they do not meet the required level. But French firms, which are already subject to a similar policy, often find it cheaper to pay the fine than to bother with high-minded greenery.

Worse, biofuels can generate as much pollution as the fossil fuels they are replacing, depending on how they are made. If electricity from coal is used to convert wheat into ethanol, say, the benefits in terms of emissions of carbon dioxide are negligible. By the same token, if rapeseed is grown using lots of fertiliser made from natural gas, then the resulting biodiesel brings relatively little reduction in emissions or fuel imports. Yet blenders and consumers have no means of distinguishing good biofuel from bad.

Biofuels from poor but sunny countries, where crops yield much more energy and costs are lower, tend to be both cheaper and more environmentally friendly. But protectionist European farmers dislike them. The EU imposes a stiff tariff on Brazilian ethanol; its specifications for biodiesel favour expensive local rapeseed oil over cheap imported palm oil.

In any case, destructive farming practices in exporting countries sometimes do more damage to the environment than burning oil or gas. Last year a Dutch study found that draining Indonesian swamps to make way for oil-palm plantations resulted in 33 tonnes of carbon dioxide emissions for each tonne of palm oil produced, by speeding up the decomposition of the peaty soil. Yet burning a tonne of palm oil instead of fossil fuel saves only three tonnes of emissions. Faced with these findings, the Dutch government has apologised for promoting palm oil, and several Dutch firms have vowed to stop using it.

Instead of trying to turn crops into fuel for transport, Europe would do better to burn them for power, says Peder Jensen, of the European Environment Agency. That would save the energy used in the conversion process. It would also generate more energy, since power plants are more efficient than car engines. On February 26th the agency will produce a report that underlines such arguments. But there is no guarantee that Europe's leaders will read it before their summit.

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Charlemagne

Singling out the market

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From The Economist print edition

Peter Schrank

The single market is the European Union's pride and joy. But it is in need of an update

THE first achievement listed on the European Commission's website is that "the EU's frontier-free single market has driven quality up and prices down." The common market is one of the few European Union programmes supported both by integrationists and Eurosceptics. Rightly so: the commission reckons that since 1992 it has boosted member states' output by 2.2% and has created 2.75m extra jobs.

All the more worrying, then, that the single market is showing signs of fatigue. It is not failing. But it is showing diminishing returns after only 15 years, supporting the case for a rethink.

A common market should make prices for similar products converge: in the absence of trade barriers, distributors will bid up prices where goods are cheap and force them down where they are expensive. Through most of the 1990s, that happened. Now it has slowed. In 2000-05 prices converged only half as fast as they had done in 1995-99.

Some slowdown was to be expected—the most egregious price differences were the first to be flattened. But signs of flagging appeared after only a decade, earlier than expected. And there are other signals. All things being equal, a common market means that trade among members should grow faster than trade with outside countries. This happened in the 1990s, when trade between EU members rose quickly, both compared with output, and with exports and imports outside the EU. But trade integration peaked in 2000. By 2005, partly because of the rise of China and others, transactions among euro-zone countries (as a share of GDP) were lower than they had been five years earlier—though the introduction of a common currency ought to have boosted trade in the euro zone. This shift is not necessarily bad. But it is not what the single market's designers planned and it suggests that, without the euro, European trade integration would have gone backwards.

A single market also ought to boost foreign investment, as firms concentrate in specialised areas (carmaking in Slovakia, say). It ought to be more efficient, and therefore more attractive to outsiders. Again, foreign investment in the single market soared in the 1990s, driven mainly by European investors. But this achievement, too, has gone backwards. Foreign investment's share of the EU's GDP has fallen since 2001.

These setbacks have not reversed the single market's earlier gains. Driven by waves of mergers, large

companies have used it to make themselves more European, more international and more successful. The stockmarket capitalisation of the world's 500 biggest listed companies shows firms based in Europe accounting for a slightly larger share of this than they did in 2003; American firms' share has fallen sharply. Should that trend continue, European firms in the top 500 would be worth more than American ones within a year or two.

The single market has a lot to do with this corporate success. According to Nicolas Véron of Bruegel, a think-tank in Brussels*, the largest European firms earned almost two-thirds of their revenue from outside their home country in 2005, whereas in 1997 that share had been only half. Revenues from parts of Europe outside their home base made up the fastest-growing slice of the pie. So big firms have become European even more than they have become international.

Yet the single market seems to have been much less successful among individuals and consumers. Firms may have gone European, but Europeans continue to shop, invest and work at home. As Mr Véron's colleague at Bruegel, Juan Delgado†, points out, the average west European country (ie, excluding new member states) spends 86% of its income on goods and services made or provided at home, and only 10% on goods from elsewhere in the EU. Europeans invest about two-thirds of their equity at home and, although there is alarm over mass migration from the east, fewer than 2% of Europeans work in another EU country. This home bias—which has roots in cultural and legal differences between nations—has not changed substantially in recent years.

Time for singlemarket 2.0

Why not? Part of the explanation is that Europe's economy has shifted towards services, which are intrinsically less tradable than goods, and which the EU has lamentably failed to liberalise properly. But another reason is the nature, not just the scope, of the single market. The basic idea in the 1980s was to encourage efficiency through economies of scale. The name of the game was market unification, not market opening; it was about harmonisation, not deregulation. One huge market, created by a single regulatory regime, would produce fierce competition, leading to fewer, bigger firms.

But the lessons of the past ten years are that jobs and innovation come disproportionately from small firms, especially from letting small firms grow big; that market entry matters more than market harmonisation; and that excessive regulation damages growth. For arch-sceptics, the cost of complying with EU red tape—supposedly €600 billion ($787 billion) annually—outweighs the single market's benefits. Some firms have done well by it, but the common market risks becoming a market for huge, stable incumbents not vibrant small firms.

The European Commission, the market's guardian, is soon to complete a review of its baby. It will be tempted to tinker, closing a few gaps in the programme. It should be bolder. It is time for a single market 2.0, focused not on more harmonisation, but on new-firm creation, on intellectual property and on more competition in sectors such as transport, energy and infrastructure that determine costs for other businesses.

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*"A Multipolar Business World" and "Farewell, National Champions", by Nicolas Véron.

†"Single Market Trails Home Bias" by Juan Delgado.

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The British army in Iraq

Bringing the boys home

Feb 22nd 2007
From The Economist print edition

Why American and British soldiers are heading in opposite directions

Get article background

ANNOUNCING the withdrawal of British forces from Basra in southern Iraq on February 21st, Tony Blair told the House of Commons that although the city was still a "difficult and dangerous place...the next chapter in Basra's history can be written by the Iraqis." If this was Mr Blair's last important statement to Parliament on the issue that has poisoned the second half of his premiership, it was a poignant acknowledgment of unfulfilled hopes.

Mr Blair said that Britain's 7,100-strong force would be cut to 5,500 over the next few months, falling next year, if conditions allow it, to 4,000 soldiers based outside the city at Basra's airport. Four years ago Britain had 40,000 soldiers serving in Iraq. Since then 132 serving personnel have lost their lives there.

AP

Leaving

Mr Blair left himself open to contradictory accusations. Some were disappointed by the slow pace of the withdrawal. Others, less numerous, pointed out that, given the American "surge" in Baghdad, it seemed a funny time to start pulling out troops. The White House put a brave face on the announcement, which critics of the war seized on to point out that even George Bush's most loyal allies were heading for the door, but it was not happy.

Given Mr Blair's desire to wind down Britain's presence in Iraq before he leaves office, he has probably struck a reasonable balance between the politically desirable and the militarily sensible. Another factor that has influenced British thinking is the difference between the security situation in Basra and that in Baghdad. In mainly Shia Basra, most of the insurgency is aimed at British soldiers rather than Iraqis. That is why General Sir Richard Dannatt, the army's head, controversially suggested that his soldiers might have become part of the problem rather than the solution.

Much will depend on the 12,500 troops of the Iraqi army's 10th division under General Abdul Latif. Trained for three years by the British and the Australians, the 10th division will increasingly take on responsibility for keeping apart rival Shia factions when they no longer have foreigners to fight. The final verdict on the British effort to make Basra a better place will depend as much as anything on whether General Latif succeeds in his mission. Mr Blair will be watching anxiously—but from the sidelines.

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Pricing drugs

A new prescription

Feb 22nd 2007
From The Economist print edition

A reform plan may prove too bold

FEW topics vex Americans more than the high price of many life-saving drugs. In contrast Britons worry about whether they can get them at all. Most recently there was an outcry about the time it took for the National Health Service (NHS) to decide to pay for Herceptin, an expensive breast-cancer drug.

British patients are not bothered about high drug prices because the publicly financed NHS foots almost all of the expense. As the Office of Fair Trading (OFT), a competition watchdog, points out in a report this week, individuals pay about 5% towards the cost of drugs prescribed by family doctors, one of the lowest shares in the world.

But if patients have little incentive to worry about drug prices in Britain, the government has every reason to do so. In 2005 the health service spent £11 billion ($19 billion) on medicines, of which £8 billion was on expensive branded drugs, mainly protected by patent, and £3 billion on the much cheaper generic versions that come on to the market once the patents expire. The OFT reckons reforming the way branded pharmaceutical prices are set in Britain could deliver economies of more than £500m a year.

Not the least of the merits of the OFT's inquiry is the light it casts on an obscure but vital part of the NHS—the agreement the government reaches with the drugs industry on prices. Under a scheme that is now 50 years old, companies can set their own prices when they start selling new branded medicines to the health service but their overall profits from sales to the NHS are capped. The OFT dislikes this approach as a matter of principle because it penalises innovative manufacturers that should benefit fully from valuable new drugs. In particular, smaller firms with only a few products may lose out.

In practice, the profit cap has ceased to constrain in recent years and the system now in effect operates through direct price controls. Firms remain free to set their own charges for new products but the government has been insisting on lower average prices when the scheme is renegotiated. In 1993 prevailing prices were lowered by 2.5%, in 1999 by 4.5% and in 2005 by 7%. The OFT criticises this blunt approach, which risks degenerating into “a strategic game in which firms attempt to guess the level of forthcoming price cuts” and the health department “attempts to second guess this effect in setting the level of price cuts”.

The competition authority advocates a root-and-branch reform to the scheme in 2010, when it is next due to be revisited. Companies would no longer be free to set their own prices for new products. The NHS would eventually negotiate with companies across the full range of their drugs, agreeing upon a price for them according to their specific therapeutic value.

The OFT says that Sweden has already started to apply such a value-based approach to the pricing of medicines. The adoption of such a reform by the NHS would have a much more profound impact on the world's drugs industry, however. Although the British market represents less than 4% of global sales, NHS prices are used by many other countries as a basis for setting their own. What happens in Britain influences markets that make up a further 25% of global sales.

The OFT's sweeping reform sounds desirable in principle but it could backfire in practice. One risk is that it could discourage firms from producing branded products that are broadly similar to a breakthrough medicine. Yet these “me-too” drugs—and the threat of them—can help to constrain prices; and some can benefit particular groups of patients. Furthermore, countries with high prices for branded drugs tend to have cheaper generic markets. In fact most of the OFT's estimated savings could already be made if doctors switched more of their prescriptions to generic drugs.

The government will also be wary about alienating the powerful drugs industry. British pharmaceutical

firms are one of the country's few success stories in an otherwise atrophied manufacturing sector. Ministers will not wish to put that achievement at risk. The current scheme undoubtedly needs a shake-up but the OFT's reform may turn out to be too bold for its own good.

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The spread of firearms

Scatter gun

Feb 22nd 2007
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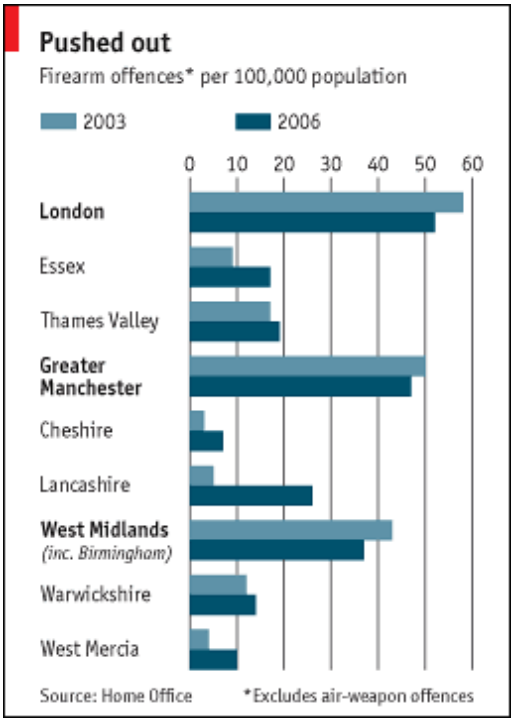
Gun crime is leaving the big cities for smaller towns



BILLY COX, aged 15, in his parents' flat; Michael Dosunmu, aged 15, in his bedroom; James Smartt-Ford, aged 16, at the local ice-rink: the lethal shootings of three south-London teenagers in less than a fortnight have startled the public and sent politicians scrambling for new initiatives. Tony Blair announced on February 18th that gunmen as young as 17 could soon face the automatic five-year penalty for illegally owning a gun that is currently reserved for those over 21. A "gun summit" with police and local leaders was scheduled for February 22nd. David Cameron, the Tory leader, said he wanted to make dads stick around as role models by giving marriage a tax break.

Is gun crime getting better or worse? Both, depending on what you look at. The government can boast of a recent dip in firearm offences (down 6% in England and Wales in the 12 months to April 2006), but only if it includes toy airguns; remove those and the number goes up a fraction. And although firearm homicides hit a seven-year low last year, injuries more than quadrupled in the same period.

The clearest and steadiest trend in all this is where gun crime is taking place: as the chart shows, guns seem to be moving out of the biggest cities and into their surrounding towns. Historically, firearms have been strongly concentrated in just three of 43 police districts in England and Wales: London, Greater Manchester and the West Midlands (which includes Birmingham). In the year to April 2002, less than a third of gun offences took place anywhere else. Last year almost half did.

Gun crime is piling up on big cities' doorsteps. Last year London's Metropolitan Police dealt with 10% fewer gun crimes per head than three years earlier, but four of their five neighbouring forces saw increases. In Essex, where gun offences almost doubled in that period, police attribute it to an upsurge in armed robberies of vans carrying cash in transit. Criminal gangs have been driven out of the capital by the Met, they say: "When you get on top of a problem like this you don't suppress it, you disperse it."

Keith Bristow, head of firearms crime at the Association of Chief Police Officers, believes drug-dealers are being similarly displaced. In an interview with the *Times* on February 19th he said that crack cocaine-dealers, along with their guns, were being forced out of cities by tougher policing and vicious competition.

Yet the overall reduction in gun crime in big cities hides a more stubborn problem. The teenagers shot dead in London this month were not bank robbers; one killing seems to have been rooted in a text-messaging row. In some dark corners, firearms are morphing from the tools of the criminal trade into the accessories of teenaged gangs, to whom crime (usually low-level drug-running) may be secondary to the desire for companionship and security.

While the Met has driven out organised gun crime, it has found such "disrespect" killings tougher to deal with. The Flying Squad, which fights "professional" crime in the capital, reported in 2004 that half its cases involved firearms. By last year this had fallen to one-fifth. In contrast Trident and Trafalgar, the police units that deal with shootings such as this month's crop (exclusively among blacks, in Trident's case), have not seen their caseload diminish in the past four years.

Most worryingly, those who suffer from gun crimes are getting younger. In 2003 16% of the victims in Trident cases were less than 20 years old. Last year the proportion was twice as high.

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Road pricing

A capital idea

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Lessons from London's congestion charge

AP

Road rage

THE Royal Borough of Kensington and Chelsea, which boasts some of the highest house prices in the country, is a byword for contented middle classes. Yet even the upwardly mobile denizens of this leafy bit of west London can be pushed too far. Last week they took to the streets to complain about the extension, on February 19th, of the city's congestion-charging zone from the commercial districts of the City and the West End to their own more residential neighbourhoods.

Their complaints attracted more sympathy than might have been expected, for road pricing has become a national talking-point in the past few weeks. People from Jeremy Clarkson (a skilful propagandist for the motoring lobby) to Labour MPs have lined up to criticise official plans for a nationwide tolling scheme, perhaps requiring the use of monitoring devices within cars. Some 1.8m people signed a public petition against it on the 10 Downing Street website, far more than all other petitions to date. Small wonder that Tony Blair took the time to e-mail every signatory defending his government's policy.

Yet “London was supposed to show that road pricing is not a political death sentence,” says Tony Travers of the London School of Economics. The capital's scheme, introduced after much opposition in 2003, has been widely seen as a success. Congestion fell by up to 30% (although that benefit seems to have eroded recently: roads are now only 8% less clogged than before 2003). The fact that the scheme works—and, more strikingly, that its chief proponent, Ken Livingstone, managed to get himself re-elected as mayor—persuaded the government to announce plans for a national road-pricing scheme in 2004. But rushing to conclusions is dangerous: London's lessons are a mixed bag.

First among them, says Stephen Glaister of London's Imperial College, is the need for a definite and coherent plan. Resistance to national road-pricing is as passionate as it is partly because the details are unknown. There is no firm date for introducing the scheme: it has been “a decade away” since 2004. The most recent study looked at 16 options, costing between £218m and £27 billion. “Which department will run it? What will they do with the money? When Ken came to the public with his plans, all this had been settled,” points out Mr Glaister.

What to do with the money is an especially thorny issue. Mr Livingstone's scheme was tolerated partly because he promised to spend the revenues on better public transport. A similar approach nationally is suggested, but the sums may not add up. London's charge brings in around £120m a year, nothing like enough to pay for better bus services. “Most of London's public-transport improvements were financed by £1 billion of Treasury cash,” says Mr Travers. “The chances that the Treasury will do something similar for every city in the country are pretty remote.”

Another option is to reduce other taxes on motoring—especially fuel duty—by the amount that road pricing raises. Such revenue neutrality would placate the motoring lobby, as well as make it cheaper to drive on quiet rural roads. But some models suggest that, while urban roads would improve, rural ones would clog up, producing more congestion overall.

Road pricing touches several nerves: motorists' perception that they are overcharged, general resentment at high taxes and worries about official surveillance. Mr Blair insists that the scheme's only motive is to tackle congestion. Such promises have been heard before, particularly from Mr Livingstone. Yet the

London charge has been dragooned into service for several other causes since 2003, notably greenery (low-carbon vehicles are exempt) and the class war (the mayor plans eye-watering charges for sports-utility vehicles).

The mayor's own officials predict that extending the scheme into residential neighbourhoods will make congestion worse by allowing more drivers to qualify for exemptions. The suspicion is that revenue-raising, not congestion-fighting, is the true motive there. The rest of the country may be right to be sceptical.

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British banking

Too clever by half

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Banks are doing well at the hard stuff. Now for some focus on the rest

A DECADE after British retail banks sounded the retreat from investment banking, they are making more money than ever from a line of business once cowed into submission by Wall Street. On February 20th Barclays, Britain's third-largest bank, said that pre-tax profit last year at its investment bank (now called Barclays Capital) had increased by 55% to more than £2.2 billion, contributing almost a third of the firm's pre-tax profit.

Royal Bank of Scotland (RBS), the country's second-largest bank, is expected to report a jump in earnings from its corporate-markets business (which includes its investment bank) on March 1st. This was the bank's fastest-growing division in the first six months of the year, producing more than half of its pre-tax profit of £4.6 billion. At HSBC Holdings, Britain's biggest bank, first-half profits from investment and corporate banking increased by more than a third from a year earlier, though it will probably say on March 5th that growth slowed in the second half.

It was not always so. Barclays and National Westminster Bank (now a part of RBS) both sold their investment-banking businesses in 1997, becoming at the time the last major British banks to abandon all hope that the country could create a national investment-banking champion.

The country's earlier contenders for that title had already succumbed to foreign takeovers. In 1995 Smith New Court, Britain's largest independent stockbroker, was sold to Merrill Lynch. S.G. Warburg, a leading British investment bank, was snapped up by the Swiss, Kleinwort Benson by the Germans and Barings Bank, a 233-year-old firm, had to be rescued by the Dutch after it was brought down by a rogue trader.

The collapse of British-name investment banking in its home market did no harm, however, to London's role as a global financial centre, nor to the country's clearing banks, three of which still rank among the world's dozen biggest by market value. But it has constantly undermined the egos of their top executives. Although perfectly good at boring commercial and retail banking, critics said, British firms lacked the flair to master the really clever bits of banking, which remained dominated by Wall Street.

Now British investment banking has staged a comeback, thanks largely to changes in financial markets. Although both Barclays and RBS had given up trying to compete with Wall Street for the lucrative business of helping companies sell shares and advising them on takeovers, both had kept the bits of their investment banks that dealt with bonds, loans and foreign-exchange trading.

As chance had it, this meant that they were well-placed to benefit from a plunge in interest rates across the world after 2001. They were also helped by hunger in financial markets for new products that allow lenders and borrowers to slice and repackage risks relating to interest rates, currency movements and loan defaults.

John Varley, the chief executive of Barclays, attributes much of Barclays Capital's success to the rising demand for debt securitisation (in which piles of small loans are packaged into securities that, like bonds, can be bought and sold) and credit derivatives (which dice and splice risk). The market for these products has grown from $1 trillion in 2001 to some $20 trillion. Few expect such good times to continue.

The irony is that, having managed in recent years to profit from investment banking, Britain's biggest banks are now tripping up over the boring stuff. Profits at Barclays's credit-card business fell for a second year in 2006 after it had to set aside £1.5 billion against bad loans. And HSBC has said that it may write off almost $11 billion in loans after dashing into sub-prime lending in America.

The next few years are likely to be tougher for British banks at home. Interest rates may well rise once more, the housing market seems to be slowing and regulators are clamping down on banks' charges. And conditions are fiercely competitive. Some analysts reckon that British banks are writing mortgage loans at a loss just to maintain market share.

Having been blinded by the bright lights of investment banking, which are expected to dim this year, investors want nothing more from Britain's top bankers than that they turn their minds to fixing their retail businesses. It may be dull and predictable, but those are precisely the qualities that shareholders most value in their banks.

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Pension losers

To heal a political sore

Feb 22nd 2007
From The Economist print edition

The only cure is a bigger bail-out

FIVE or so years ago workers in final-salary pension schemes discovered an ugly truth. If a company sponsoring such a plan went bust and there turned out to be a big shortfall in the pension fund, employees could lose a large chunk of their expected retirement benefits.

AP

Left in the lurch no longer

The predicament of workers whose hopes for a prosperous old age had been dashed was a wake-up call for the government. It responded by establishing the Pension Protection Fund. Financed by levies on private defined-benefit pension plans, the PPF provides a financial safety-net for workers whose firms fold with a hole in their pension schemes.

The PPF does not provide full protection. But the deal it has offered workers since April 2005 is a lot better than the fate suffered by many people whose companies collapsed before then. Up to 125,000 are thought to be affected, and 80,000 of them have suffered significant losses. The government has offered them limited support through the “financial-assistance scheme”, but this falls a long way short of what they might expect to get from the PPF, let alone full compensation.

Understandably, they have mounted a vigorous campaign to get redress. In 2006 their spirits were raised by Ann Abraham, the parliamentary ombudsman who can investigate whether public maladministration has caused individuals to suffer an injustice for which there has been no remedy. She delivered a scathing report on how successive governments had mishandled their responsibility towards workers who relied on the promise of final-salary pension schemes. The government rejected both her findings of maladministration and her main recommendation for full compensation, however.

On February 21st the campaigners scored a hit when a high court found that the government had been wrong to reject the ombudsman's findings. In particular, the judge agreed with Ms Abraham that an official leaflet issued in 1996 saying that company pensions were “protected whatever happens to the employer” was misleading. He did not back some of her other conclusions, such as a possible causal link between official information and the eventual losses that workers have incurred. But he told the government to reconsider her recommendation for restitution in the light of his judgment.

Whatever the legal position, ministers are aware that they are on weak political ground. The aggrieved

individuals have a strong moral claim. Significantly David Cameron, the Tory leader, focused on the issue on February 21st in his weekly sparring match with Tony Blair in the House of Commons. Labour is vulnerable because the problem emerged on its watch and followed Gordon Brown's big tax raid on pension funds.

Resolving the matter will require more money from hard-pressed taxpayers, who must also be considered. The government's commitment through the financial-assistance scheme has a present value of £800m. That is much less than the amount needed to deliver full redress: official estimates put that cost at between £2.9 billion and £3.7 billion. But as John Ralfe, a pensions specialist, points out, the bill could fall substantially if the government offered partial compensation along the same lines as the PPF. Such a compromise would heal a long-running political sore.

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Bagehot

Something is stirring

Feb 22nd 2007
From The Economist print edition

Steve O'Brien

It looks as if voters have started to make up their minds about Gordon Brown and David Cameron

FIRST, a health warning. Opinion polls that make big headlines should be handled with care. Any poll that breaks from the pack could be a "rogue"—something may have gone wrong with sampling or some exceptional event may have skewed it. Secondly, there are inherent problems with polls that ask respondents to think how they will feel about something that has not yet happened. But all caveats aside, the ICM poll published this week in the *Guardian* was a humdinger.

When asked how they would vote if Gordon Brown, David Cameron and Sir Menzies Campbell were the leaders of their parties, the result was a 13-point lead for the Conservatives under Mr Cameron. It was their best rating with ICM since the immediate aftermath of John Major's general-election victory in the summer of 1992 and enough to give them an overall majority of between 50 and 70 seats. It would take only another percentage-point shift from Labour to the Tories to put Mr Brown in similar territory to that of Michael Foot, who led the party to its worst election result since the end of the first world war.

The *Guardian* pulled no punches, splashing pictures of Mr Brown and Mr Cameron with their respective poll ratings—29% and 42%—across the front page. Inside, an editorial argued that such were the doubts about Mr Brown's electoral appeal that Labour MPs had a duty to ensure that a proper leadership contest takes place, not the coronation that everyone expects.

Three quite big and important things appear to be going on. The first is that a sort of positive feedback loop has been established in which the long-standing misgivings about Mr Brown within his own party are now being projected back to it by the voters. Senior Labour figures glumly go through the motions of declaring in public their utter confidence in Mr Brown's prime-ministerial credentials. He is the most successful chancellor of the exchequer since records began, a political heavyweight of towering intellectual stature and soaring moral purpose. It's a testimonial just close enough to the truth not to provoke sniggers, but they and we know it's only half the story. What increasingly worries ministers, and those Labour MPs in southern seats whose majorities hang by a thread, is that, unless he can reveal a different side to his personality, dour, stiff, slightly odd Mr Brown will struggle to reach those aspiring middle-class voters whom Mr Blair could still just about deliver in 2005.

The second big thing is that the mood of the electorate seems to be swinging from apathetic boredom and irritation with the government to a feeling that maybe it's time for a change. If that is right, Mr Brown, for all his admirable qualities, is the last person on earth who can deliver it. However much Mr Brown and his supporters insist that Labour will look very different when he is prime minister, the fact is that Mr Brown is universally recognised as the joint-architect of the government's successes and failures. It is hard to see what sort of meaningful fresh start Mr Brown can offer.

That was the argument made last week by Frank Field, an independent-minded Labour MP. Mr Field reminded his colleagues that the Tories were able to win a remarkable fourth successive election partly because Margaret Thatcher's replacement, Mr Major, emerged from nowhere. Even Mrs Thatcher, who backed Mr Major's leadership bid, had only the haziest idea what he was really like (and was bitterly disappointed when she found out). But it meant that the Tories were able to claim plausibly that by choosing the obscure, untainted Mr Major they had already given the voters the change they demanded.

Mr Field went on to suggest that if Labour was serious about winning it should thank Mr Brown for his outstanding service and move on to the next generation in the shape of David Miliband, the 41-year-old environment secretary who for some time has been uncomfortably cast in the role of next-leader-but-one. That is where Mr Field's line of reasoning runs out of steam.

Mr Miliband is bright, articulate, charming and terribly modern. But his recent handling of a bird-flu outbreak in a turkey factory did not inspire confidence. Mr Miliband has also consistently and convincingly ruled himself out as a contender for the leadership. Either he genuinely believes he is not ready or he has concluded, like other cabinet colleagues, that a Quixotic tilt against Mr Brown would be a very bad career move. Only a small number of Labour MPs—perhaps no more than a fifth— await Mr Brown's apparently inevitable ascension with unfeigned enthusiasm. The rest are now divided between the bleakly resigned and the frankly terrified.

Bouncing Brown

The other factor behind that fourth Tory victory was that the more people saw of Labour's leader, Neil Kinnock, the less they liked the thought of him as prime minister. The third big thing that may be happening this time around is that voters are inching towards the opposite conclusion about Mr Cameron.

Mr Cameron's strength is that despite his privileged background (and rumours of a dissolute youth) he brims with empathy, as Tony Blair did long ago. After a stream of stories about teenagers in south London gunning each other down and a UNICEF report on child wellbeing that put Britain last out of 21 developed countries, Mr Cameron made a speech about putting children first. Its theme of helping families and encouraging social responsibility were familiar Cameron riffs, but the speech resonated powerfully and was widely reported. By comparison, Mr Brown's attempt to grab attention by promising to try and bring the 2018 World Cup to England was clumsy, only reminding people of the rising costs of putting on the Olympics in 2012.

No doubt there will be some sort of “Brown bounce” when Mr Blair finally hands over the keys to Number 10. But this week the odds against Mr Brown sustaining it lengthened.

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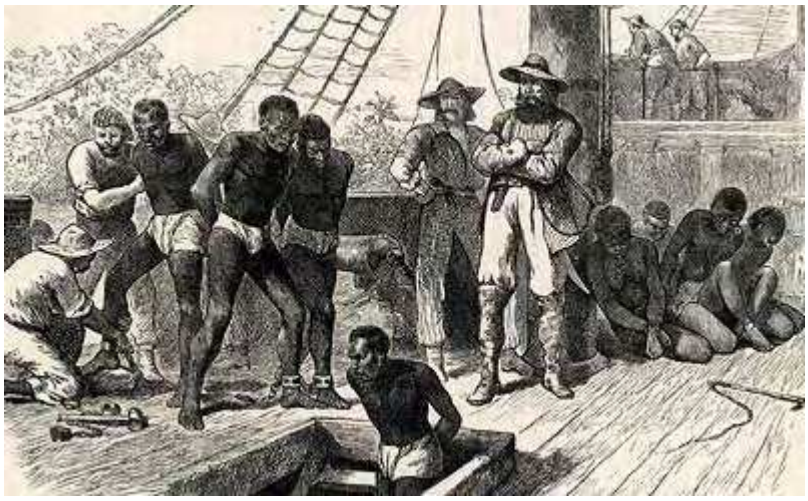
Slavery

Breaking the chains

Feb 22nd 2007 | CAPE COAST, GHANA
From The Economist print edition

Britain abolished the slave trade 200 years ago this week. Its landmarks are an abiding legacy of cruelty

Mary Evans



THE dungeons can still shock, two centuries after their last inmates were freed. Damp and fetid in the tropical air, immersed in virtual darkness, this is where slaves were kept, often for months at a time—before being led down a tunnel through the “door of no return” to ships riding in the surf, ready to begin their appalling voyage over the ocean.

Just one of the countless inmates left a written record. Having been sold to white traders for a gun, a piece of cloth and some lead, Quobna Ottobah Cugoano recalled waiting in the dungeon till his time arrived: “To conduct us away to the ship, it was a most horrible scene; there was nothing to be heard but rattling of chains, smacking of whips, and groans and cries of our fellow men. Some would not stir from the ground, when they were lashed and beaten in the most horrible manner.”

When the dungeons were excavated in the late 19th century, a mass of caked excrement was removed, together with the bones of birds and animals on which the slaves presumably fed. On such misery was founded a global trading system that in its heyday, in the mid-18th century, was taking about 85,000 Africans a year across the Atlantic to work on sugar and tobacco plantations that made Europe rich.

Cape Coast Castle was the grandest of the slave emporiums, at the centre of the trade. But in present-day Ghana, then called the Gold Coast, there were over 30 more slave forts, built and maintained by almost all of the European trading powers of the day: the Swedes, Danes, French, British, Dutch and Portuguese.

The “triangular trade” as it was known, whereby slave-ships left European ports for west Africa with rum, guns, textiles and other goods to exchange for slaves, and then transported them across the Atlantic to sell to plantation-owners, and then returned with sugar and coffee, also fuelled the first great wave of economic globalisation. Slavers in France would send their shirts to be washed in the streams of the Caribbean isle of St Domingue, now Haiti; the water there was said to whiten the linen better than any European stream.

At one point the plantations of St Domingue provided two-thirds of France's overseas wealth. By the mid-18th century, though, Britain was the biggest slaving nation, and ports like Bristol, Liverpool and London

thrived as a result.

So integral to the British economy was the slave business that there were few men and institutions of wealth who did not want to invest in it, from the royal family and the Church of England downwards. Slavers could count on the Archbishop of Canterbury to defend them before God, and on politicians, like the young William Gladstone, himself the son of a plantation-owner, to plead their case in Parliament.

Given how entrenched the slave trade was at the time, it is remarkable that a campaign to abolish it which began in 1787 succeeded only two decades later. It was 200 years ago this week that a bill to abolish slavery got through its second, decisive reading in Parliament.

Ultimately it was the shame and degradation that the slave traffic brought to those involved, perpetrators as well as victims, that proved its undoing. And the atmosphere of shame is still palpable in the places where the transatlantic trade started, on the African coast.

Given the trade's vast scale, some call it a holocaust. Up to 20m Africans were taken across the Atlantic between the 15th and 19th centuries, denuding many places of their most able workers. The slaves were not meant to be killed, or even worked to death (though many did die); there was no effort to wipe out a race. Still, as the writer William St Clair points out, in one way the analogy with Nazi death camps works—in “the organised fictions, hypocrisies and self-deceptions that enabled otherwise reasonably decent people to condone, to participate and to benefit.”

For most Europeans the existence of the slave trade, and slavery itself, was barely known. In England there was no slavery, so there was no particular reason for most people to face the ugly truth.

The means by which sugar lumps arrived on tables in polite society were carefully hidden. The young officers of the African Service who volunteered to man the slave forts and oversee the dungeons were children of the age of enlightenment. They saw themselves as well-endowed with all the refined feelings and sensibilities that could be expected of a gentleman.

Those fine feelings were spared from reality by careful euphemisms. There were no slave-traders; only “adventurers” in the “Africa” or “Guinea” trade. Prints of the gleaming white Cape Coast Castle made it look like a European palace; there was no hint at its real role. Shackles used to string captives together were just “collars”. The “Company of Merchants”, which ran Britain's slave trade, had on its logo an elephant and a beehive—denoting Africa and America—but nothing about slaves.

Of an evening, officers of the African Service might peruse a new work of history or philosophy: an eerie precursor of the Nazi officers who relaxed to the sound of Beethoven after a day in the gas chambers.

But there was still a pervasive feeling that, despite all the evasions, those involved in the trade were doing something deeply wrong. In the courtyard of Cape Coast Castle lies the tomb of Philip Quaque, the chaplain to the officers and men of the castle for 42 years in the second half of the 18th century. During all that time he failed to bring a single officer to the Christian rite of Holy Communion. In a letter he reflected that this had nothing to do with his (black) skin-colour, and more to do with a mood of shame: “The only plea they offer is that while they are here acting against Light and Conscience they dare not come to that holy Table.”

An essay that mattered

This sense of guilt was to prove the Achilles heel of the slave trade in Europe. The task the abolitionists set themselves was to expose the reality of the trade to an ignorant public. They thought the moral sense of ordinary people would do the rest, and in part they were right. But lighting the spark of conscience needs brave individuals—like Thomas Clarkson, the moving spirit behind the founding of the Society for Effecting the Abolition of Slavery in 1787. He had been a student at Cambridge University two years before. He entered the university's Latin essay contest, set by a vice-chancellor who was also an early abolitionist. The title was: Is it lawful to make slaves of others against their will? After two months' research, he not only won the prize but also dedicated the rest of his long life to the cause of abolition. A large man with thick red hair, he would brook no compromise. A friend scolded him for being “deficient in caution and prudence”, but his lack of these qualities gave him the anger and energy to succeed.

If anyone was the founder of the modern human-rights movement it was Clarkson. Even the Quakers,

the first abolitionists, were impressed by his zeal. It was essentially the alliance of Clarkson, an Anglican, and the Quakers, with their existing network of preachers and supporters, that made up the abolitionist movement; in an ironic nod to their success, slavers would call their ships the *Willing Quaker* and the *Accomplished Quaker*.

Clarkson fixed the strategy of the campaign. His first task was to gather evidence about the slave trade, not easy when things were so hidden from public view. He spent long periods in Liverpool and Bristol, trying to gather testimony from the captains or doctors of slave ships, or freed slaves. Almost nobody would talk to him, but over the years small chinks opened in the wall of silence.

One who came forward was John Newton, a former slave captain turned Anglican priest. His descriptions of the trade were very influential. Just as important was Clarkson's gathering of the physical evidence of the slave trade to confirm the oral and written accounts he collected. In Liverpool he picked up “collars”, thumbscrews and a device for force-feeding slaves, which he would display at the hundreds of public lectures that he gave all over Britain, and France too.

But Clarkson's greatest coup was to get hold of a “plate”, or diagram, of the slave-ship *Brookes*, owned by a Liverpool family of that name, which operated between the Gold Coast and Jamaica. Clarkson and others reworked the plate to show the *Brookes* loaded with 482 slaves, lined up in rows and squashed together. As always, Clarkson and the abolitionists were strictly accurate; the ship had once carried over 600 slaves in even closer confinement, but they did not want to be accused of exaggeration. In 1789 they published 700 posters of this image and it was a sensation; nobody could now deny the horrors of the “middle passage”, during which many slaves either killed themselves or died of disease, starvation and cruel treatment. It became the abiding image of the campaign, rather like the thin and haunting faces of the newly freed inmates of the Belsen concentration camp.

Clarkson also organised what was probably the first ever consumer-goods boycott, of slave-grown sugar, to bring home to ordinary Britons at their tea tables the message that they were paying a dreadful price in human cruelty for indulging a sweet tooth. At one time more than 300,000 people joined the boycott, also designed to hit the profits of the plantation owners. And he inspired the parliamentary movement against slavery, recruiting as spokesman a young Tory, William Wilberforce (see article), who brought successive bills before Parliament to abolish the slave trade until one was passed in 1807.

Copy, copy and copy again

In its tactics, boycotts, moral zeal, lobbying, research and its use of images, the British campaign was a template for many later ones—against slavery in the Belgian Congo in the late 19th century; against apartheid in South Africa; and against segregation in the American south.

For all the fervour of its opponents, the slave trade would not have collapsed without rebellions by the victims. The most important was in 1791 on St Domingue. Within two months the slaves had taken control of the island, led by the remarkable Toussaint L'Ouverture. His guerrillas saw off the two greatest imperial armies of the day, the French and British; this led to the establishment of the republic of Haiti in 1804 and to the emancipation of about 500,000 slaves. It was clear that European armies would find it hard to contain many more uprisings, a point proved again on the British islands of Grenada and Barbados. Samuel Sharpe's uprising on Jamaica in 1831 was put down at great cost; the British feared that if slavery continued, they would lose some colonies altogether. So in 1833 slavery was abolished throughout their empire.

Britain was not the first to outlaw the slave trade in its territory; the Danes had done so in 1803, the French temporarily in 1794 and several northern American states had also done so before 1807. But as Britain was the big sea power of the day, it alone could enforce abolition throughout the world, as its navy resolutely tried to do for the rest of the 19th century. Other European nations, notably the Portuguese, persisted with the trade into the 1860s.

The European and American role in the slave trade is now well-known and governments, such as Britain's and France's, as well as individual cities have apologised. There will be much talk about apologies this year. Some will ask whether words of regret are enough. In America slave descendants are fighting a long-running legal battle, in a class-action lawsuit, to get financial compensation from corporations alleged to have benefited from slavery.

In Ghana, meanwhile, Nii Anum Akwete Momli, the chief of slave descendants in the village of Sesemi,

north of the capital Accra, says some compensation is arriving already—in the form of electricity and water, part of an aid package from Denmark, another slave-trading nation.

Most European states have tried to face up to the past, but slavery's legacy is in some ways even more poisonous in places like modern Ghana. A smokescreen still covers the African role in this pernicious trade. It is an awkward fact that the traffic could not have existed without African chiefs and traders. Europeans rarely went far from their forts; slaves were brought to them. Indeed, when the Europeans arrived the slave trade and slavery were already integral parts of local tribal economies. One of the few Ghanaian historians to touch these issues, Akosua Adoma Perbi, writes that “slavery became an important part of the Asante state [the Gold Coast's most powerful] right from its inception. For three centuries, Asante became the largest slave-trading, slave-owning and slave-dealing state in Ghana.”

When the Portuguese arrived on the scene in 1471, they were intermediaries, bringing slaves (and other goods) from Senegal and Benin along the coast to Ghana to sell them in exchange for gold to the Asante and other local peoples. The Asante then mounted slave-trading expeditions to get labour for gold mines.

The forts themselves were not owned by the Europeans; the land on which Cape Coast Castle was built was rented to the British by the local chief for a monthly sum. It was in the interests of the Europeans to respect local customs and laws, as that included the institution of slavery. This meant that they could take slaves but not, for instance, kill animals for amusement; when one officer, James Swanzy, shot a crocodile there was a huge fuss and compensation was paid.

AP

Ghana's slave dungeons: still a shock, two centuries on

Most of the slaves sold to Europeans in later centuries were men and women captured in battles between tribes like the Asante and the Acan. Many of the captives were kept as slaves by the victors, where they were treated relatively well and could gain some social standing within their new families. Still, the proliferation of wars between the tribes was, as Ms Perbi writes, “mostly aimed at acquiring slaves for sale to the European companies and individual European merchants”. So integral did the slave trade become to the local chiefs' welfare that its abolition hit hard. In 1872, long after abolition, Zey, the king of Asante, wrote to the British monarch asking for the slave trade to be renewed.

Yaw Bedwa of the University of Ghana says there has been a “general amnesia in Ghana about slavery”. The role of the chiefs is particularly sensitive, as they still play a big role in Ghana. “We don't discuss slavery,” says Barima Kwame Nkye XII, a paramount chief in the town of Assin Mauso. He defends domestic slavery in the past as a generally benevolent institution, and insists that the chiefs had little to do with the slave trade.

The wounds of slavery are still too raw to be exposed in public, even more so as the stigma of slavery remains attached to slave descendants who, in some cases, still cannot inherit property. Mr Bedwa faces anger from African-Americans who come to Ghana looking for roots, only to be confronted with the role of Africans in the slave trade. Mr Bedwa tells them that Africans who did not suffer from slavery were still victims of colonialism, poverty and disease. But, as in every exploitative system, some had it worse than others.

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A contested mantle

A new tug of war

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Let him go, he's ours

TO WHOM does William Wilberforce—the best-known figure in the British campaign to end slavery—belong? As with many historical figures, his mantle is contested by devotees of different political hues.

To progressives, he was, of course, a pioneer of campaigns for social justice. To modern British Tories, he embodies a sort of compassionate conservatism of the kind that the party's present leader, David Cameron, is keen to proclaim.

In the end any analysis of the real William Wilberforce has to draw on theology as well as politics. He can hardly be understood except in the context of a strain of evangelical Christianity, one that stresses sin and atonement, to which he was converted in 1787.

That in turn has made him an attractive figure for parts of the conservative camp in the United States. Whereas Americans used to look upon Wilberforce, in a fuzzy way, as an equivalent of Abraham Lincoln, the British abolitionist has now acquired fans on the religious right. Sam Brownback, a Republican senator from Kansas, says his life was changed by a biography of Wilberforce. This explains the senator's agitation over killings in the Sudanese region of Darfur, and his concern over sex trafficking. Like his hero, Mr Brownback has undergone a conversion; evangelical by background, he became Roman Catholic after a brush with cancer. Others on America's right link Wilberforce with opposition to abortion.

Wilberforce professed two goals in life: to abolish slavery, and to redeem British “manners”—or raise the nation's moral tone. He saw the abolition of slavery as part of a broader project to bring the world closer to God. He campaigned against “vice” or licentious behaviour—gambling, drunkenness or promiscuity—after growing alarmed at the frequency of execution by hanging. If lesser sins were dealt with sooner, fewer people would commit serious crimes, he felt.

On the face of things, such a stringent world view would sound absurd in the chaotic diversity of modern Britain. But nobody should be surprised if some stern form of conservative Christianity, claiming the legacy of Wilberforce, emerges in one small corner, at least, of the politico-religious spectrum. The shocks of secularism, immigration and rival faiths have already shaken up the complacency of Anglicanism in peculiar ways. One day Britain might have its own version of Senator Brownback.

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Places in the sun

Feb 22nd 2007
From The Economist print edition

Gary Neil

Offshore financial centres are booming, thanks to their easy-going tax regimes. But the best of them are more than tax havens: they are good for the global financial system, argues Joanne Ramos

IF THE deal over North Korea's nuclear-weapons programme holds, Kim Jong Il may be able to indulge his penchant for fine wines and Hollywood blockbusters again. Banks around the world had severed ties with North Korea after America last September blacklisted a Macau bank accused of doing business with the hermit kingdom, making foreign money tighter for the Great Leader. But a move towards more normal relations with America could help restore the flow.

The financial system is modern warfare's newest front. In a globalised economy money moves instantly and anonymously across borders. This can benefit terrorists, drug traffickers and rogue nations in need of cash. Keeping such customers out of the world's sprawling financial system is becoming ever harder.

Financial regulators have another big concern. Footloose capital transmits not just tainted money but financial crises too. The huge growth in the use of esoteric derivatives and the rise of hedge funds have made it increasingly difficult to understand where financial risk lies, partly because much of it is hidden away on islands with variable supervision.

But the most vexing problem that highly mobile financial flows pose for governments is that when they cross borders they may take tax revenues with them. This is particularly serious for rich Western countries with ageing populations that they will have to support in retirement. Such countries have launched a raft of initiatives to strengthen the international financial system against the undesirable side-effects of financial globalisation: financial crime, financial contagion and tax evasion. The idea is to prod financial centres worldwide to adopt international best practice on bank supervision, the collection of financial information and the enforcement of money-laundering rules.

One group has become the object of special scrutiny: offshore financial centres (OFCs). These are typically small jurisdictions, such as Macau, Bermuda, Liechtenstein or Guernsey, that make their living mainly by attracting overseas financial capital. What they offer foreign businesses and well-heeled individuals is low or no taxes, political stability, business-friendly regulation and laws, and above all discretion. Big, rich countries see OFCs as the weak link in the global financial chain.

In the past OFCs have indeed permitted various dodgy doings. Critics think their dependence on foreign capital encourages them to turn a blind eye to crime and corporate fraud within their borders. Sani Abacha of Nigeria, Mohammed Suharto of Indonesia and Ferdinand Marcos of the Philippines are just a few of the corrupt leaders who have looted their countries, helped by the secrecy offered not just by certain tax havens but also by some onshore financial centres, a point often ignored by the OFCs' critics.

Some of the money used for the terrorist attacks of September 11th 2001 was funnelled through Dubai, which has recently set itself up as a financial centre. The accounting scams at Enron, Parmalat and Tyco were made easier by complicated financial structures based in OFCs (though, again, also in onshore centres such as Delaware).

Tax wars

But the most obvious use of OFCs is to avoid taxes. Many successful offshore jurisdictions keep on the right side of the law, and many of the world's richest people and its biggest and most reputable companies use them quite legally to minimise their tax liability. But the onshore world takes a hostile view of them. Offshore tax havens have “declared economic war on honest US taxpayers”, says Carl Levin, an American senator. He points to a study suggesting that America loses up to $70 billion a year to tax havens.

The Tax Justice Network, a not-for-profit group that is harshly critical of OFCs, reckons that global tax revenues lost to OFCs exceed $255 billion a year, although not everybody believes it. Canadians were alarmed by a government report showing that Canadian direct investment in OFCs increased eightfold between 1990 and 2003, to C$88 billion ($75 billion)—a fifth of all Canadian direct investment abroad. The bulk of this was in financial services, mostly in a few Caribbean countries.

Business in OFCs is booming, and as a group these jurisdictions no longer sit at the fringes of the global economy. Offshore holdings now run to $5 trillion-7 trillion, five times as much as two decades ago, and make up perhaps 6-8% of worldwide wealth under management, according to Jeffrey Owens, head of fiscal affairs at the OECD. Cayman, a trio of islands in the Caribbean, is the world's fifth-largest banking centre, with $1.4 trillion in assets. The British Virgin Islands (BVI) are home to almost 700,000 offshore companies.

All this has been very good for the OFCs' economies. Between 1982 and 2003 they grew at an annual average rate per person of 2.8%, over twice as fast as the world as a whole (1.2%), according to a study by James Hines of the University of Michigan. Individual OFCs have done even better. Bermuda is the richest country in the world, with a GDP per person estimated at almost $70,000, compared with $43,500 for America (see chart 1). On average, the citizens of Cayman, Jersey, Guernsey and the BVI are richer than those in most of Europe, Canada and Japan. This has encouraged other countries with small domestic markets to set up financial centres of their own to pull in offshore money—most spectacularly Dubai but also Kuwait, Saudi Arabia, Shanghai and even Sudan's Khartoum, not so far from war-ravaged Darfur.

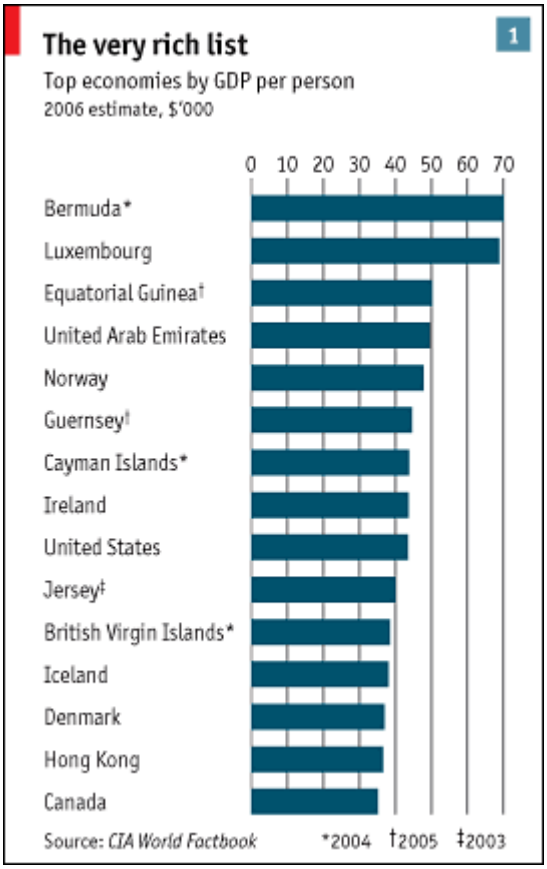
Globalisation has vastly increased the opportunities for such business. As companies become ever more multinational, they find it easier to shift their activities and profits across borders and into OFCs. As the well-to-do lead increasingly peripatetic lives, with jobs far from home, mansions scattered across continents and investments around the world, they can keep and manage their wealth anywhere. Financial liberalisation—the elimination of capital controls and the like—has made all of this easier. So has the internet, which allows money to be shifted around the world quickly, cheaply and anonymously.

The growth in global financial services has helped too. Financial services are in essence the business of managing data. “It is zeros and ones,” says Urs Rohner, the chief operating officer of Credit Suisse, a Swiss bank, adding that “in no other industry do you see the impact of globalisation as enormously and dramatically as in finance.” This is because these zeros and ones can be traded, structured, lent and sold anywhere. Profits can be booked almost anywhere, too, and are increasingly being shifted to OFCs.

The growing importance of the financial-services industry in many economies means that a greater chunk of profits—and tax liabilities—are easily moved offshore. A paper published last year by Alan Auerbach of the University of California at

Berkeley found that whereas in 1983 financial corporations accounted for only about 5% of all corporate-tax revenues in America, between 1991 and 2003 they made up roughly a quarter.

The taxman also has to worry about non-financial companies that are acting like financial ones. The main profit engine for General Electric, a large American conglomerate that makes everything from jet engines to plastics, is its finance division. Non-financial companies run pension funds and stock-option plans for their employees across the world, manage their corporate treasuries in myriad currencies and increasingly employ esoteric financial products such as derivatives to hedge risks and raise money. All of these activities can be set up in OFCs and often are, supported by an army of lawyers, accountants and investment bankers.



Parasites or pioneers?

OFCs are often portrayed as financial parasites that survive by diverting tax and other revenues from “real” economies, offering a haven for tax cheats and money-launderers. Some of this undoubtedly goes on—but it goes on in big onshore economies as well.

Businessmen and wealthy individuals insist that OFCs can play a legitimate role in reducing tax liabilities. The business community in particular argues that in a fiercely competitive global economy where national tax regimes can vary widely, minimising tax payments is a competitive necessity and OFCs are one solution. OFCs themselves insist that they are specialist financial centres and have far more to offer than just low taxes.

The main argument against OFCs is that by allowing companies and affluent individuals to avoid taxes, they sap tax revenues from “real” countries, limiting those countries' ability to pay for public services and forcing them to tax less mobile factors such as labour, housing and consumption. The big risk is that

“globalisation is perceived to be rigged against the average citizen,” says David Rosenbloom, formerly the international tax counsel at the Treasury Department in America.

Critics also worry that OFCs do not supervise business within their borders tightly enough, which gives crooks an opportunity to enter the global financial system and could allow sloppy practices that might spark wider financial crises. Certainly, as many OFCs themselves will admit, only a couple of decades ago regulation in many offshore jurisdictions left much to be desired and bad money found its way in with the good. OFCs argue that this has changed and their supervision is now at least as good as onshore, sometimes better.

Libertarians say that tax, regulatory and other competition is healthy because it keeps bigger countries' governments from getting bloated. Others argue that OFCs may be an inevitable concomitant of globalisation. “Even if today's OFCs were somehow stamped out, something like them would pop up to take their place,” says Mihir Desai of Harvard Business School. Some academics have found signs that OFCs have unplanned positive effects, spurring growth and competitiveness in nearby onshore economies.

Should anything be done about OFCs? Countries try to discourage investment in tax havens through the tax code and pour resources into tracking down tax cheats. But this is a Sisyphean task—close one regulatory loophole and lawyers will open another; convince one OFC to co-operate in the fight against tax evasion or financial crime and another will take its place.

International organisations have launched various initiatives to try to get OFCs to tighten supervision, co-operate more with foreign governments to catch tax cheats and, at least in Europe, eliminate “harmful” tax practices. OFCs think such initiatives are designed to force them out of business. The countries that set these standards “are an oligopoly trying to keep out smaller competitors. They are both players and referees in the game. How can they be objective?”, asks Richard Hay, a lawyer in Britain who represents OFCs.

What is clear is that globalisation has changed the rules of the game. It has produced many benefits for rich countries, but has also provided more opportunities for tax leakage, which explains their anxiety over OFCs.

OFCs, for their part, have by and large done well out of globalisation. Two decades ago, they were mainly passive repositories of the cash of large companies, rich individuals and rogues. Some jurisdictions still ply this trade today and should be put out of business. But the best of them—for example, Jersey and Bermuda—have become sophisticated, well-run financial centres in their own right, with expertise in certain niches such as insurance or structured finance.

This special report will argue that although international initiatives aimed at reducing financial crime are welcome, the broader concern over OFCs is overblown. Well-run jurisdictions of all sorts, whether nominally on- or offshore, are good for the global financial system.

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What it takes to succeed

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From The Economist print edition

Gary Neil

Not only low taxes but a great deal besides

THE Jersey cow, a small, honey-brown bovine that is prized by farmers for the abundance of buttery, high-fat milk it produces, is one of the fastest-growing breeds in the world. From its origins in Jersey, a rocky island 14 miles (22km) off of the western coast of France, it now wanders fields in over 100 countries from South Africa to Latin America. It is Jersey's most famous export. But the island's real cash cow is financial services. Jersey's 46 banks, 1,055 investment funds and over 200 trusts administer over £700 billion in assets on the island. In St Helier, Jersey's capital, they compete for office space with more than two dozen law firms, 50 accountancy outfits and 20 insurance companies.

Jersey's transformation into an OFC was not part of a grand plan. After the second world war Jersey's low taxes attracted the bank deposits of British expatriates living in the former colonies. The island's maximum rate of income tax of 20% had remained untouched since 1940 when it was set by the German occupiers.

But tax was only the beginning. Jersey used its role as a low-tax repository of cash to build up a sophisticated private-banking and trust business. More recently it has moved into the corporate business—structured finance, the administration of investment funds, the management of company share plans and the like.

Other OFCs developed in similar ways. Many of them are small territories that were once part of Britain (a number of them are still dependencies). Often they had a history of low or no taxes long before they began to attract the deposits of British expatriates and others. As money flowed in, the cleverer ones began to diversify into more sophisticated businesses. They also began to promote themselves as broad financial centres, not just banking ones. This suited Britain, because it meant its protectorates could become self-sufficient. It also suited the jurisdictions themselves. Financial services are lucrative and provide a much more stable income than crops and fickle tourists. Mauritius hoped to diversify away from sugar, textiles and tourism and attract skilled labour when it launched itself as a financial centre in 1992. Barbados, a poor country reliant on sugar, received help from the IMF and other agencies when it established its financial industry in the 1970s.

Given the attractions, why are there not even more OFCs? After all, cutting taxes to attract foreign capital seems an easy way out of poverty. A study published last December by Mr Hines and Dhammika Dharmapala of the University of Michigan looked at 209 countries and territories, including 33 tax havens, to see why some jurisdictions become tax havens and others do not. Those that do, they found, are overwhelmingly small, wealthy and, especially, well governed, with sound legal institutions, low levels of corruption and checks and balances on government. Badly run jurisdictions cannot attract or retain foreign capital, so many do not even try. Slashing tax rates is not nearly enough.

This may explain why the British empire spawned so many successful OFCs. These jurisdictions inherited strong legal and governmental institutions that reassured investors. Lingering ties to Britain probably helped, too. The appeals process in the BVI and Jersey, among other OFCs, ends up in Britain. Other jurisdictions that have tight cultural or linguistic ties to nearby large financial centres also benefit from a ready clientele happy to do business in a familiar place. Liechtenstein, for instance, does well out of being perched next to Switzerland and using the Swiss franc as its currency.

Whiter than white

Being a successful OFC is tougher than it used to be. The best-run of them compete not only with offshore rivals but also, in certain industries, with onshore ones. Bermuda's biggest competitors in captive insurance (of which more below) are Vermont and South Carolina.

The costs of running OFCs have also increased. Complying with the raft of international standards for financial services introduced since the late 1990s involves a lot of effort. And as standards rise, more is expected of the public companies that use OFCs as well. They must not only make profits, but be good corporate citizens too: paying bosses enough but not too much, for instance, making sure their operations in poor countries are run ethically (no child labour, no sweatshops) and steering clear of shady jurisdictions. So OFCs that are careless about their reputation may find themselves shunned by the big, listed multinationals that are their lifeblood.

OFCs complain that the bar is set higher for them than for their onshore counterparts. When Stanley Works, an American toolmaker, announced in 2002 that it was moving its headquarters to Bermuda, it caused a furore. Along with other firms that had moved to tax havens, including Tyco and Ingersoll Rand, it was pilloried as “unpatriotic”, even though it was acting entirely legally. Partly as a result, new American captive-insurance businesses now often stay onshore. A regulator in Europe comments: “Tax havens have to be whiter than white. It is the only way to shake off their bad reputation—which some of them deserved not too long ago.”

Being whiter than white does not come cheap. Introducing anti-money-laundering and other regulations, beefing up bank supervision and tracking down financial crooks takes money and expertise. A paper published last August by the Commonwealth Secretariat, a group of 53 former members of the British Empire, estimated that in 2002-05 the direct cost of new regulations for Barbados was $45m and for Mauritius $40m—big numbers for tiny islands with small budgets. The indirect hit could be even bigger. For example, the number of offshore banks in Vanuatu plummeted to 7 from 37 in a year after new rules required banks to open a permanent office with at least one full-time employee on the island. The paper concludes that for these three jurisdictions, “the costs involved in meeting the new standards have exceeded...identifiable short- to medium-term benefits.”

The start-up costs for new OFCs are also much higher than they used to be. As one regulator in a tax haven explains, in the old days jurisdictions were able to build a critical mass of business before turning their attention to legal and regulatory structures. Many OFCs that opened their doors in the 1960s and 1970s have put in place anti-money-laundering systems only in the past few years, for instance. This means that some bad money came in with the good that had to be flushed out later.

These days new OFCs must invest in regulation, legislation and enforcement up front. That explains why some of the newer ones are wealthy countries that can afford to do this. Dubai, for example, has spent billions of dollars setting up the legal and supervisory systems to underpin its new financial centre. A big chunk of this money was spent on hiring regulators, mostly from Britain.

Some countries have decided that all this is more trouble than it is worth. Tonga, Niue and Nauru, three miniscule islands in the Pacific Ocean, have quit offshore banking to avoid the cost of meeting international standards, as, in effect, have the Cook Islands.

Getting down to business

So what does it take to run a successful OFC? First and foremost, you need a tax system that foreign capital finds attractive but still pays the bills. The model that most OFCs choose keeps corporate taxes low or does away with them entirely but makes up for this through a combination of indirect taxes and fees, which are in any event easier to collect.

Regulation, too, is critical. It must be “necessary, appropriate and proportional...and benefits [must] outweigh costs,” asserts Timothy Ridley, chairman of the Cayman Islands Monetary Authority. That applies not only to OFCs but also to big financial centres such as New York and London. The job is never easy, but a risk-based supervision regime, which most OFCs use, is more manageable in small jurisdictions because supervisors tend to know most of the movers and shakers. Moreover, in such places regulators tend to be easy to reach and take the gripes of the business community seriously. Regulators in Singapore, for instance, habitually consult local businesspeople to see how they can improve co-operation. Their clients say this is not just public relations. “They are willing to listen and change. They are not rigid like regulators in Japan and Korea,” says one banker at a British firm.

In the nature of things regulation in small OFCs can also be simpler than in big countries. In America, for instance, a national insurer may find itself being regulated by each of the 50 states. In Bermuda, by contrast, “you can focus simply on running a sound business and making money—not on red tape,” says Karole Dill Barkley, an insurance consultant.

More importantly, many OFCs are involved mainly in wholesale rather than retail business. Of the Cayman Islands' $1.3 trillion in bank deposits, 93% are interbank bookings, not personal or corporate accounts. The 8,000-plus hedge funds domiciled in Cayman cater only to rich, sophisticated investors able to look out for themselves, so regulators do not have to worry about protecting widows and orphans and can streamline procedures. In the BVI hedge funds can be set up and registered within a couple of days.

Gary Neil

The two pillars of Bermuda's insurance industry—captive insurance and reinsurance—also cater to sophisticated businesses only. Captives are set up by companies (or groups of them) to lower their insurance bills by covering predictable risks themselves. British Airways, for instance, until recently had a captive in Bermuda that insured its aviation and other risks. Because no third parties are involved, regulators in Bermuda apply a lighter touch. Reinsurers underwrite part of the risks of other insurance companies. They are subject to stricter disclosure rules in Bermuda because, under many contracts, unrelated third parties are at risk.

One way OFCs maintain a light touch is to involve auditors and other service providers in regulation. Jeremy Cox, the supervisor of Bermuda's insurance industry, describes the island's way of doing things as “practical regulation that tries to use the experience of industry”. Bermuda also puts some of the regulatory onus on independent auditors, who must sign off on insurers' annual filings and confirm that they meet minimum liquidity and profitability standards.

In Cayman all regulated or licensed professions—including lawyers, auditors, fund administrators and auditors, insurance providers and service providers for trusts—are required to blow the whistle if they suspect that something untoward is going on. This is separate from the money-laundering rules.

Jack be nimble, Jack be quick

For all OFCs one of the advantages of being small and predominantly reliant on the finance industry is that they can change existing rules and laws quickly to react to new opportunities. Inevitably this takes much longer in big, diversified economies, where any change in the status quo involves difficult negotiations among an assortment of interest groups.

Thanks to its nimbleness, Singapore has been able to score a number of successes against Hong Kong, its slower-moving rival. New trust laws in Singapore that came into effect a year ago have prompted Hong Kong to re-examine its own. Singapore was also ahead of Hong Kong in passing legislation on real-estate investment trusts (REITs), a relatively new investment class in Asia that has been growing rapidly, fuelled by the local property boom. “We are small in a big world. We survive because we stay ahead of the region,” says Kelvin Chan, a former government official who is now with the Partners Group, a Swiss private-equity firm. “In this, being small is our strength.”

Luxembourg manages to move quickly even though it is part of the EU and must comply with all EU

directives, which have become increasingly onerous over the years. Luxembourg dominates the market for a type of investment fund called UCIT, similar to mutual funds, that complies with stiff requirements so that it can be sold freely throughout Europe. This is because it was the first country to incorporate the UCIT directive into law in the 1980s.

Being quick on one's feet is important for OFCs not only because competition is fierce but because many offshore products are easily commoditised. There is nothing particularly special about a Cayman-domiciled hedge fund, for instance; indeed more offshore hedge funds are domiciled there than anywhere else, and lawyers have so much practice that they can quickly set up another one. Hedge-fund managers themselves look for safety in numbers. “You go there because everyone else does,” says one New York investor. BVI companies are popular in Asia for much the same reason: they are familiar, they work, and everybody else uses them.

OFCs with critical mass and expertise in certain niches often act as subcontractors for financial institutions in big onshore centres in the same region. Investment bankers in London, for instance, often work with bankers in Jersey on mergers and acquisitions. Bankers and lawyers in Cayman work with the lawyers of American multinationals on structured-finance transactions.

Such expertise helps OFCs to beat off the competition. Bermuda's reinsurance market is flourishing because it relies on a network of brokers, underwriters and actuaries that would be hard to replicate. By contrast, fund administration—in essence, the back-office work for investment funds—which thrives in Dublin, Jersey, Luxembourg, the Isle of Man and elsewhere, has become commoditised for run-of-the-mill equity funds. This is one reason why so many OFCs are fighting over hedge-fund business. Administering these funds requires expertise in areas such as valuing illiquid instruments and complex securities such as derivatives, so margins are fatter and clients tend to stick around.

But small jurisdictions sometimes find it difficult to attract and retain the people to provide the expertise. OFCs in balmy climates or close to onshore economies do better than tiny islands floating in the middle of the South Pacific. Proximity to “real” economies makes it easier to lure those experts (almost always expatriates), and clients also like the convenience of being in the same time zone as their OFC and talking to people in their own language.

Some islands are running out of space. Jersey, for instance, imposes strict housing restrictions. Bermuda is facing even greater strains on its capacity. Households are limited to owning one car to cut down on traffic, so affluent businessmen can be seen zipping to work on motorscooters. Getting permanent residency in Bermuda is difficult and house prices are vertiginous, not least because unlike most other OFCs Bermuda is the home base of many huge global businesses with large numbers of employees.

The influx of well-paid expatriates who drive up the cost of living can cause tensions with the local population. Kurt Tibbetts, a government minister in Cayman, says his government works on preserving social harmony by pouring money into education. Bermuda quietly pursues affirmative-action policies that give locals first refusal of any jobs before expatriates can be considered. For the leading OFCs, success comes with its own headaches.

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On or off?

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It's a matter of degree

WHAT exactly is an offshore financial centre? At its broadest, it is any financial centre that takes in a large chunk of foreign funds—in other words, almost every financial capital in the world. Much of the business conducted in places such as New York, London or Hong Kong is from outside America, Britain or China.

Britain is arguably one of the biggest personal-tax havens in the world. So-called “resident non-domiciles”—people who live in Britain but claim domicile abroad—do not have to pay tax on offshore income. America, for its part, soaks up huge amounts of offshore cash because it taxes little of the money held in its banks by non-resident foreigners. Foreigners' bank deposits in America add up to $2.5 trillion, well over twice as much as those in Switzerland.

But as most people understand the term, “OFC” means a smaller jurisdiction where the lion's share of the institutions are controlled by non-residents and many of them are in the financial sector or set up for financial reasons. The volume of business conducted by these financial institutions often far outstrips the needs of the local economy.

When OFCs combine all these attributes with a low- or no-tax regime they are tagged as “tax havens”, especially if they also have strict banking-secrecy rules, light supervision and a slack grip on business within their borders. Panama, for instance, still allows bearer shares that can be anonymously owned and traded.

The Financial Stability Forum (FSF), a group that monitors threats to the global financial system, has put together a list of 42 jurisdictions that it defines as OFCs. The OECD in 2000 compiled a narrower list of 35 tax havens. There is a great deal of overlap between the two.

Dividing the world into onshore and offshore financial centres is difficult because “it is a matter of degree, not substance,” says one European bank regulator. For example, many people consider Bermuda an OFC, but it is packed with actuaries pricing reinsurance risks. Jersey, where the financial sector accounts for over half of all tax revenues, is home to a sophisticated banking industry, co-operates with other governments on tax matters and requires banks and other licensed institutions to have a “real presence” on the island.

More confusingly, some jurisdictions straddle both categories. One example is Luxembourg, a tiny country sandwiched between Belgium, France and Germany and one of Europe's most important financial centres. A founder-member of the EU, Luxembourg is considered a well-managed, soundly regulated financial centre with real expertise. It is home to more than 2,200 investment funds with almost €1.8 trillion under management. It is also the euro zone's biggest private-banking centre. The financial-services industry contributes a third of Luxembourg's output and, including its indirect contribution (accountants, lawyers and the like), supplies around 40% of Luxembourg's tax take.

Luxembourg is sometimes lumped with tax havens because of various scandals involving companies based there, including the notorious BCCI and, more recently, Clearstream. But although Luxembourg got most of the bad press, BCCI was operated out of London and Clearstream is mainly a French affair.

Ireland and Singapore are big in manufacturing but also have thriving financial centres that cater to offshore business. Singapore has strict rules on banking secrecy and does not consider foreign tax evasion a crime. Some people consider Switzerland as a tax haven because of its low tax rates and its fabled banking secrecy.

But onshore economies can be opaque too. A report issued by a government agency in America last April

found that few states collect information on the true owners of companies set up within their borders. Delaware and Nevada are particularly lax.

Mr Owens at the OECD prefers to differentiate between well and poorly regulated financial centres rather than onshore or offshore ones. Well-regulated centres co-operate with foreign tax and other authorities and have sound supervision; poorly regulated ones hide behind secrecy. Low or no taxes on their own, says Mr Owens, do not constitute a harmful tax practice.

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Moving pieces

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Gary Neil

Global companies have plenty of latitude to minimise their tax bills

IT WAS as if America had swallowed Sweden. Since George Bush signed into law a one-off tax amnesty in 2004 that slashed corporate-tax rates from 35% to just over 5%, American companies have repatriated close to $350 billion in previously untaxed foreign profits, according to estimates by JPMorgan, a bank—just shy of Sweden's annual output. Pfizer, a drugs company, alone brought home an eye-popping $38 billion. Well over $150 billion of American companies' foreign profits still sit offshore.

Companies the world over are increasingly global. They are also facing ever fiercer competition at home and abroad, which makes them increasingly sensitive to costs—including the costs of regulation and tax. That is good for OFCs, often the low-cost middlemen of international financial transactions.

The way companies use OFCs has changed over the years. A few decades ago, before the telecoms revolution made it easy to shuffle money around the globe, companies used OFCs primarily because they had less onerous financial rules. The links between banks in Cayman and those in America, for instance, are rooted in a long-standing American rule barring banks from paying interest on commercial chequing accounts. To get around this, many American banks set up “sweep accounts” that electronically funnel money to Cayman for an interest-earning overnight stay before being swept back home. “Cayman takes advantage of a legitimate loophole—and the financial system is none the weaker for it,” says one regulator in Europe.

Luxembourg got established as a financial centre four decades ago partly because it had looser lending rules than other European countries such as Germany, says Fernand Grulms of the Luxembourg Bankers Association. A Luxembourg subsidiary of a German bank could make over twice as many loans for the same amount of equity as its parent. Scandinavian banks were drawn to Luxembourg because they could deal in foreign currency there, which at the time was prohibited at home.

Regulation still matters. In Europe many countries, including Germany, France and Italy, until recently did not allow onshore hedge funds, says Tom Whelan of Greenwich Alternative Investments. That gave offshore hedge funds a chance to establish themselves. In America three-quarters of onshore hedge funds have offshore clones, mainly because hedge funds with foreign investors, who are not required to pay taxes on their hedge-fund investments in America, would still need to file America's unwieldy tax returns if they invested onshore.

These days the main attraction of OFCs for companies is the prospect of lower tax bills. Because of fierce global competition, being as tax efficient as possible is just as important as keeping down labour costs and overheads, which often entails a different kind of offshoring.

In extreme cases companies have moved their headquarters to a tax haven to slash tax bills. In America new rules were introduced a few years ago to stop such “corporate inversions”, and have recently been tightened further. But a clutch of British insurers, including Hiscox and Omega Underwriting, have recently moved to Bermuda to minimise tax.

Most companies have gone for a half-way house, staying put but using OFCs to cut their tax bills. To understand how this is done, a quick tax tutorial is in order.

Broadly speaking, countries opt for one of two kinds of tax system. The first taxes companies and people on their worldwide income, irrespective of where it was earned. This method is used by America, Britain and Japan, among many others. To avoid double taxation, a company receives a credit for the taxes it pays to foreign governments up to the amount it would have paid had it remained at home.

The second, simpler method, called the “territorial” or “exemption” system, taxes only profits earned in the home country. This system is used by the vast majority of OECD countries, including France, Canada and Switzerland. For example, France would tax Total, the energy company, on the profits it earns in France but not on those it earns in Venezuela or Kazakhstan.

For companies taxed under the worldwide system, the most straightforward way to use OFCs to minimise taxes is to send money offshore and keep it there, as Pfizer did. This is because countries that tax companies on worldwide profits do not present the tax bill for foreign profits until these have been repatriated.

There are four other main ways in which companies can use OFCs to avoid tax, regardless of where they are based and what tax regime they fall under. The first three do not worry the taxman; the fourth gives him sleepless nights.

The first of the less worrying sort involves moving a physical business—such as a manufacturing plant—to a tax haven and then attributing as much profit to it as possible. Ireland is a prime example of this strategy in action. The second is setting up a company in a tax haven to tap its favourable tax-treaty network. Mr Owens of the OECD notes that the vast majority of foreign direct investment in India over the past decade has been channelled through nearby Mauritius because of its tax treaty with India. Cyprus's tax treaty with Russia makes it a favourite for companies investing in that country.

A third involves companies setting up in OFCs that are “tax neutral”—that is, the main attraction is avoiding extra layers of tax rather than avoiding tax bills. For example, an American mortgage-lender might sell a chunk of its mortgages, and the mortgage payments that go with it, to a Cayman company. This company would not make any profits; it would simply repackage the streams of mortgage payments into bonds and sell these to investors. In Cayman it would not be taxed, but onshore it might have been.

The taxman's nightmare

The strategy that gives the taxman nightmares involves shifting profits from high-tax to low-tax jurisdictions. This is done either by transferring a company's financial risk (and its potential future profits) to an OFC, or by exploiting the ambiguities of transfer-pricing rules which govern how multinationals divide up their profits among the countries they operate in.

An example of a risk-transfer scheme would be a company set up in Luxembourg to finance the research and development of a drug in high-tax Germany. Such a manoeuvre could cut both ways. If the drug were a success, profits would be booked in Luxembourg and taxed at a low rate. But if the drug bombed, the company would lose out on the higher tax losses it would have been able to book had it kept everything in Germany.

Financing companies of this type can be set up to pay for all sorts of initiatives that can later be credited with boosting profits to be taxed offshore—a big advertising campaign, investment in technology and the like. Companies can also structure loans between subsidiaries in high- and low-tax countries to achieve the same end.

Another way to minimise taxes is to shift the risk of joint ventures or other transactions offshore. Companies based in the BVI, for instance, are now the second-largest investors in mainland China after Hong Kong, says Robert Briant, a partner at Conyers Dill & Pearman, a law firm based in Bermuda. Many

of these investments involve joint ventures.

The second big stick in the corporate treasurer's tax-avoidance armoury is transfer pricing. Companies have a lot of latitude in setting the price that subsidiaries charge each other for goods and services. This can shift profits away from high-tax countries by attributing higher expenses and lower profits to them. This is no small matter for tax authorities: an astonishing 60% of international trade takes place within multinational firms.

The question of where a company creates value, and thus where its profits should be taxed, is tricky at the best of times. Companies are increasingly managed on regional or even global lines, not national ones. It makes little sense to have a separate risk or research division each for France, Germany and Italy, for instance. And a large and growing chunk of the value companies create comes in the form of intangible assets such as patents or brands. These are hard to value as well as exceedingly mobile.

Most countries calculate transfer prices on the basis of what two independent companies would pay on the open market. But many services and intangible assets, say a unique patent or a global brand, do not have a market price, so it is hard to estimate what they are worth. That leaves ample room for quibbling—and, say the tax authorities, manipulation.

Gary Neil

These schemes have deprived the taxman of a lot of revenue. A government report published in 2004 found that 61% of American companies paid no federal income tax during the boom years of 1996-2000. Much of this was thanks to moving profits—rather than actual business—to tax havens, reckons Martin Sullivan, editor of *Tax Analysts*. He looked at Internal Revenue Service data from 1998 to 2000 and found that profits before tax of subsidiaries of American companies during this period grew by $64 billion, or 45%, to $208 billion, with over half of this increase coming from low-tax countries, particularly Bermuda, the Bahamas, Denmark and Cayman. The average effective tax rate on the foreign profits of American multinationals during this period dropped from 24.2% to 20.8%.

Transfer pricing in particular is coming under increasing scrutiny. Mark Everson, the IRS Commissioner, told a group of senators last August that the challenges posed to the agency by transfer-pricing manipulation “are acute and ever growing. Offshore abuses are a real problem.” A study by Andrew Bernard of the Tuck School of Business at Dartmouth, Bradford Jensen of the Institute for International Economics and Peter Schott of Yale School of Management conservatively estimates that the IRS loses at least $5.5 billion and maybe as much as $30 billion from the manipulation of transfer pricing each year.

Such numbers have made tax authorities in America, Canada and Britain more belligerent. Late last year Merck, a drugs company, disclosed that it is facing four disputes with American and Canadian tax authorities that could cost it $5.6 billion in additional taxes and interest. Another drugs-maker, GlaxoSmithKline, last autumn settled a 16-year transfer-pricing dispute with the IRS for over $3 billion.

Some believe that the best way out for companies is to assign transfer prices according to a formula based on the number of people and amount of property they have in each country. But in practice this does not really make things easier, says Peter Merrill of PricewaterhouseCoopers. For a start, there is no common tax base in a common currency across countries, so there is no coherent pool of taxable profits to allocate by such a formula. Intangible property would still have to be valued. And the formula would probably not work for companies involved in a range of different businesses such as Toyota, which apart from making cars is also involved in businesses such as housing, financial services and biotechnology.

The real problem is that globalisation has rendered the current system of taxing multinationals archaic. Taxation is based on national boundaries, but companies operate across continents and can easily shift money and physical assets around. Until tax systems reflect that reality, the difficulties will persist.

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Rich pickings

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Gary Neil

How to defeat tax cheats

"IN THIS world nothing is certain but death and taxes," Benjamin Franklin famously proclaimed. But for the well-heeled and well-advised, only the grim reaper is a dead certainty. The private bankers of the rich can find ways to structure transactions that greatly reduce their tax bills and sometimes eliminate them altogether. This often involves moving money offshore.

According to Boston Consulting Group, offshore private-banking assets total almost $6 trillion. Some of this wealth is stashed offshore for safe keeping by the well-to-do from politically turbulent parts of the world. But most of it is there to minimise taxes—sometimes legally, often not. Most OFCs do not levy capital-gains or inheritance taxes, nor taxes on passive income such as interest. Strict banking-secrecy rules in some of them can shield assets from the taxman as well as afford protection from unscrupulous governments. In a number of jurisdictions—including Switzerland, Luxembourg and Singapore—not paying taxes owed to foreign authorities is not a crime. Other OFCs, including many in the Caribbean, do not have any laws against tax evasion because they impose no income taxes.

These benefits have persuaded some prosperous people to set up house in sunny tax havens. Popular destinations include Monaco, a city-state of two square kilometres on the Riviera that Ringo Starr and Roger Moore call home; Switzerland, abode of Tina Turner and Boris Becker; Andorra, squeezed between France and Spain; and various Caribbean islands.

Other jurisdictions are trying to elbow into this business, not so much to draw tax exiles as to attract entrepreneurs who bring with them (taxable) businesses and brainpower. Last year the Isle of Man capped income tax at £100,000, in the hope of convincing London investment managers of the charms of island living. Guernsey plans to impose a £200,000 cap.

Singapore is trying to edge out Hong Kong as a home for hedge-fund investors and bankers by offering permanent residency in two years or less and a low-tax, business-friendly environment, as well as a bit of fun. "One problem we face is that hedge-fund managers are young and lively," a former government official explains, "and compared with Hong Kong we are boring." So Singapore has recently reversed a law that banned dancing on bar-tops, opened a slew of new bars and restaurants and loosened restrictions on racy films.

Famous tax exiles make good headlines, but there are relatively few of them. Most of the rich would rather stay put, moving only their assets to tax havens. One simple way to do this is to open a bank account in an OFC that does not tax interest payments. These are meant to be disclosed to the taxman at home, but often are not. Tax dodgers can tap these funds from afar by using debit and credit cards, although tax authorities are now cracking down on this.

One way to get round this is by setting up a trust. This involves putting money, property and other assets into an independent legal entity and designating someone reliable to manage it. Trusts had their origins in the Crusades. Knights would assign their land and other possessions to a trusted friend to take care of their affairs should they die abroad.

Trustworthy

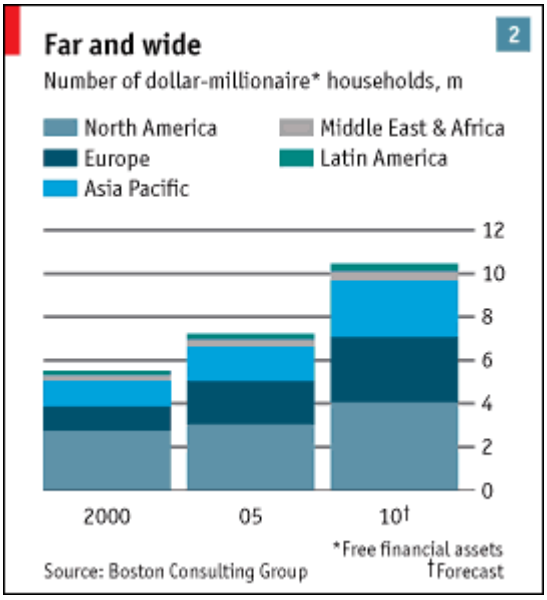
These days users of trusts have more mundane motives. If a trust is set up in a tax haven, assets often accumulate in it free of tax as long as they remain offshore. Money can also be passed on to heirs through the trust, avoiding inheritance taxes. And trusts are a nifty way to protect assets from an angry spouse in the event of a divorce. Long popular in America and Britain, they have now caught on in Europe and, increasingly, Asia.

Another method by which the wealthy can squirrel some of their assets offshore is by setting up a company. It is a particularly straightforward way to hold disparate and worldwide assets—such as land, factories and investments—and transfer them to heirs or spouses, who can take a stake in the company. Such companies can be relatively simple to set up. BVI, one of the cheapest places for doing this, gets a lot of business out of it.

The use of trusts and companies offshore can minimise some taxes—such as inheritance tax—and defer others, such as income tax, until the money is brought home. Both are standard tools in tax planning for the affluent. What has made them controversial is their lack of transparency. Most jurisdictions, including America and Britain, do not regulate trusts. Bermuda, Cayman, Jersey and the BVI do—a point of particular pride for OFCs—but it is still hard to get information on them. Companies are an even bigger problem, as they can be set up easily either onshore and offshore without much disclosure.

The number of people using these methods to minimise their tax bill is burgeoning. One reason is that there are many more rich people than there used to be. According to Boston Consulting Group, global wealth in 2005 increased by 8% to $88.3 trillion and the number of millionaire households (those with over $1m in assets under management) reached 7.2m (see charts 2 and 3).

The fastest growth came in the developing world—which arguably needs tax revenues even more than the rich countries do. Between 2000 and 2005 the number of millionaires in India and China increased by over 15% a year, followed by Brazil and Russia with 10%. Many wealthy people in such countries deposit money abroad because they fear tumult, or a grasping government, at home. The rich in Hong Kong, itself a low-tax jurisdiction, move assets offshore in part because they are wary of the Chinese government.



In developed countries OFCs are no longer the exclusive preserve of the very rich. The “mass affluent” too—dentists, doctors, prosperous small businessmen—are placing money offshore and putting a broader swath of the tax base at risk. Technology has played a big part in this. Anyone who types the words “offshore bank account” into an internet search engine will score over 1.7m hits, many of them offering advice on how to set up offshore bank accounts, trusts and companies, all at reasonable rates. Electronic banking is providing easier access to untaxed offshore funds. Promoters of tax havens are now also marketing their wares to a broader audience. Where once they advertised only in airline magazines handed out in first-class cabins, they have now embraced business class and, on some airlines, even economy class.

Affluent people these days also lead more cosmopolitan lives. Expatriate employees of multinational firms are likely to manage their financial affairs offshore, completely legitimately. So are owners of overseas holiday homes, who often deposit the rent in offshore bank accounts offshore without telling the taxman—definitely illegal, but often hard to track down.

Taxman taxed

All of this makes the taxman's job harder, particularly in countries with worldwide tax systems. American tax authorities have waged war on “abusive” tax shelters—complicated transactions with no economic purpose other than avoiding tax—and the bankers, lawyers and accountants who sell them.

These are particularly damaging to government revenues because they are often standardised and sold to the wealthy by the thousands. The government not only has to unearth such inappropriate tax shelters but to convince the courts that even if they are technically legal they have pushed the boundaries too far.

America's Internal Revenue Service has notched up some big wins. Its biggest, in August 2005, was in a court case against KPMG, one of the world's top four accountancy firms. The IRS accused KPMG of peddling a series of tax shelters to rich investors, involving Cayman and other OFCs, which generated $11 billion in phoney tax losses and deprived the government of at least $2.5 billion in tax revenue. KPMG admitted to criminal tax fraud and paid $456m in fines. That sent a signal to tax accountants and lawyers everywhere to watch their step.

But rather than trying to bend the rules, many should-be taxpayers just hide. Given the current state of technology, this is relatively simple to do because bank accounts can easily be set up over the internet and used from afar. So the tax authorities have to go in through the back door. In 2000 the IRS convinced the American courts to grant it access to the details of thousands of credit- and debit-card accounts linked to (untaxed) offshore accounts in the Bahamas, Antigua and elsewhere, which allowed it to collect some $270m in tax.

The IRS hopes there will be even richer pickings to come. Last spring it won permission to inspect the records of customers of PayPal, eBay's online payment system, who have bank or payment-card accounts in tax havens. The IRS suspects that some of PayPal's 100m accounts worldwide are being used to dodge taxes by using money in offshore accounts to buy goods online.

Britain's Inland Revenue last year won a landmark case obliging Barclays, a British high-street bank, to hand over the bank details of hundreds of thousands of offshore accounts held by British residents. The Revenue estimates that this could yield up to £1.5 billion in unpaid taxes. Other British banks may hear from the taxman soon.

The Australian tax authorities, too, have cracked down on the use of payment cards to draw money from offshore bank accounts. They have reportedly found that over A$10m a day is leaving Australia for Jersey and Guernsey, the Caribbean and other OFCs.

British, American, Australian and Canadian tax authorities hope to unearth more such scams by joining forces. In 2004 they set up the Joint International Tax Shelter Information Centre (JITSIC) to share information on abusive tax shelters and their promoters. Critics complain that such invigilation will eventually lead to the establishment of a global super-cop with the power to pry, unchecked, into people's private affairs. They would prefer tax amnesties to persuade people to repatriate their money. But when this method was used by a handful of countries in continental Europe, the result—the repatriation of about $200 billion—was generally seen as disappointing.

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Unintended consequences

Feb 22nd 2007
From The Economist print edition

Gary Neil

The less obvious uses of tax havens

FRANCE has always taken pride in its refusal to embrace the harsher aspects of capitalism and globalisation—from its 35-hour work week to laws that make it difficult to sack employees. But in a global economy no one can sit still. In a new year's speech to labour unions and companies in January, Jacques Chirac, France's president, called for cuts in France's corporate-tax rate from 33% to 20%, and as low as 10% for some companies. That is below Ireland's 12.5%, at which the French have often sniped in the past.

Yet it is OFCs that are seen as tax rogues, for two reasons. First, they are seen to be spurring tax competition among countries. True, some onshore economies are doing much the same, but OFCs use taxes to attract mobile financial capital (and profits) without any “real” business underpinning it. Second, OFCs are thought to be aiding tax evasion, the unlawful avoidance of tax. These two issues are often confused.

The risk of tax competition is that it could spiral out of control, starting a “race to the bottom” as real economies cut tax rates on mobile capital and transfer the tax burden to labour and other immobile factors in order to keep up with lower-tax competitors. This prompts other countries to follow suit—and so on and downward. In the bleakest scenarios social-welfare models would crumble because governments would be unable to pay for public services and there could be a backlash.

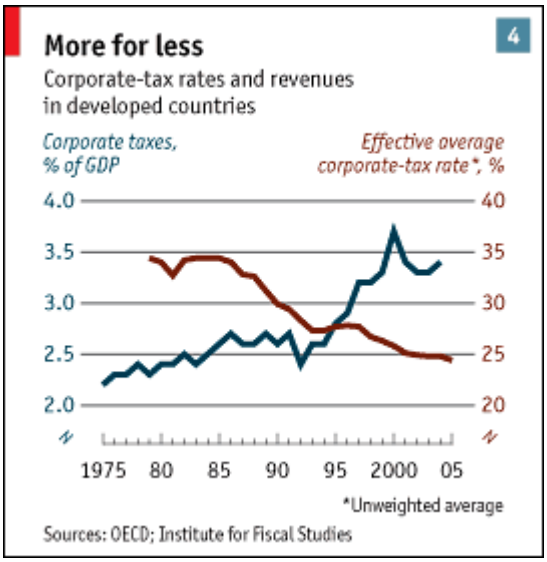
Poorer countries could also find it harder to compete on taxes, reinforcing the perception that globalisation is unfair. A recent paper by Harry Garretsen and Jolanda Peeters of the Central Bank of the Netherlands analysed annual data for 19 OECD countries from 1981 to 2001 and found that big, rich countries, such as Britain and Germany, were better able to resist tax competition and maintain high corporate tax rates than smaller, poorer ones. It concluded that “if there is a race to the bottom, it seems that it is more real for some countries than others.”

But for now that is still a big “if”. A stack of academic studies has documented that foreign investment is sensitive to tax rates, and Mr Garretsen and Ms Peeters found in their study that footlose capital did indeed lead to tax competition. A 1% increase in their measure of capital mobility was associated with a 0.5% drop in effective corporate-tax rates.

But this competition does not seem to have started a downward race. As a proportion of GDP, total tax revenues have increased steadily over the past 30 years even as statutory tax rates have fallen. This is true even in the EU, where drops in statutory tax rates have been particularly dramatic. Effective average corporate-tax rates have also fallen (see chart 4). Yet according to a paper published last June by Gaetan

Nicodeme of the Solvay Business School in Brussels and the European Commission, corporate-tax collections in Europe as a proportion of GDP have remained stable over the past decade, at around 3%. He says this may be because lower tax rates have allowed countries to attract a large corporate-tax base.

Even if it does not cause a race to the bottom, tax competition is not necessarily benign, says Michel Aujean of the European Commission. Corporate profits have boomed in recent years and tax collection has followed. More companies are being set up, so there are more to be taxed. And in many countries cuts in statutory tax rates were accompanied by measures that closed loopholes, thus broadening the tax base. All this means that the numbers may not be as reassuring as they seem to be.



Oxfam, a not-for-profit group that works to alleviate poverty, says tax competition is already very real for poor countries. In a report published in 2000 it estimated that developing countries lose at least $50 billion a year to tax havens, about the same amount as rich countries dole out to poor ones in foreign aid.

John Christensen of the Tax Justice Network takes issue with the term “tax competition”. He says that “true competition spurs productivity and efficiency in the market, while tax incentivisation—which is what this is—only increases after-tax profits. The two are not the same.” He argues that the tax regimes of OFCs and their onshore copycats distort economic decisions.

Many economists and businessmen disagree with Mr Christensen, arguing that competition of any kind is a healthy, disciplining force. “Tax competition is the only agent of productivity for governments—it is the only competition they have,” says Jacques de Saussure, a partner at Pictet & Cie, a Swiss private bank. But he agrees that it can go too far, because the rich tend to be more mobile than the poor and can hire advisers to minimise their tax bills.

Complements or substitutes?

Even those in favour of tax competition seem to assume that tax havens take business (and hence taxable profits) away from onshore economies: that the amount of economic activity in the world is fixed and that a dollar booked in Guernsey is a dollar less for France. However, a wealth of academic research has shown that when a company opens a plant abroad, demand in its home country gets a boost too: sales by the parent company grow and jobs and exports at home tend to rise. But does this also hold true if profits are simply shifted to tax havens?

A fascinating study published in 2006 by Mr Hines of the University of Michigan and Mr Desai and Fritz Foley of Harvard Business School provides evidence that it does. Looking at data on American multinational companies from 1982 to 1999, the economists found that tax havens boosted economic activity in nearby non-havens rather than diverting it.

They offer two possible explanations for this surprising result. The first is that a company's subsidiaries in tax havens may add value by providing important intermediate inputs used by its operations elsewhere. The second, more interesting one is that in helping multinational companies lower their effective tax rates—even if this is done simply by profit-shifting—OFCs could make high-tax countries more attractive to foreign investors. So a relatively high-tax country such as France might see a drop in foreign investment if nearby tax havens went out of business, because foreign companies would no longer be able to use them to minimise French tax bills.

If true, this opens up the possibility that tax havens complement onshore jurisdictions rather than substituting for them, and that the interaction between the two increases total economic activity in the world. If the pie gets bigger, then both tax haven and onshore jurisdiction will benefit. An interesting side-effect may be that onshore economies are able to maintain higher general levels of income tax because mobile capital, which is sensitive to tax rates, will help itself to a lower effective tax rate by using OFCs. “Tax havens are like pressure valves,” says Mr Hines. “The companies that might otherwise leave a high-tax country for a lower-tax home stay put because they can use tax havens to lighten their

tax load.”

This could be the reason why governments in onshore jurisdictions the world over do little to stop the use of tax havens, even though they constantly complain about them. British politicians, for instance, sometimes talk about scrapping their country's rule on resident non-domiciles because it allows wealthy people domiciled abroad, often in tax havens, to live in Britain tax-free. That would simultaneously increase Britain's tax take and seriously dent the offshore business of nearby tax havens. Yet nothing is ever done, perhaps because doing away with the rule would cause an exodus of wealthy and often brainy residents that would hurt the economy more than the tax forgone. Similarly, America and others could quite easily curb the use of tax havens by tightening those parts of the tax code that already penalise the use of OFCs, but they choose not to do so.

In a paper published last spring, Andrew Rose of the Haas School of Business at the University of California at Berkeley and Mark Spiegel of the Federal Reserve Bank of San Francisco argue that OFCs may offer other benefits too. They studied the banking sectors of 221 countries and territories and found that the nearer a country was to a tax haven, the more competitive and efficient its banking system appeared to be. “Offshore competitors can keep onshore banking sectors on their toes,” explains Mr Spiegel. “They probably facilitate sleaze but can still have unintended positive effects.”

Laundry list

The sleaze factor is conspicuously absent from all these studies, which concentrate on the OFCs' role as low-tax jurisdictions. But what if a low-tax OFC is shoddily regulated or its rules are opaque?

By definition there are no reliable figures on money-laundering worldwide, because its perpetrators try to make the proceeds of financial crime indistinguishable from legitimate money. Michel Camdessus, a former managing director of the IMF, once estimated the amount of money laundered globally at 2-5% of world GDP. Based on world output in 2005, that would put the current figure at about $2.1 trillion. This is a problem not just for tax havens but also for some onshore financial centres. Augusto Pinochet, the Chilean dictator, hid millions of dollars with the help of Riggs Bank, based in Washington, DC.

The proportion of illicit funds that is detected is minuscule, and would be even tinier without co-operation across borders. This is where criticism of OFCs is justified. Some of them have rules that make it very difficult to exchange information with foreign enforcement authorities. Others do not register the companies that set up on their shores, so could not provide such information even if they wanted to. Cayman does register its offshore companies, of which it has over 70,000, and willingly assists foreign law-enforcement agencies, but it does not require companies to disclose their beneficial owners, so the information is not all that helpful.

Other financial centres that co-operate on money-laundering and other criminal investigations balk at sharing information on tax matters. This includes not just OFCs but onshore jurisdictions with strict banking-privacy rules.

Jurisdictions that cling to secrecy rules are “selling a shield against the laws of foreign governments”, says Mr Merrill. “Enforcement is almost impossible when faced with this shield.” Indeed, although tax revenues have been on the upswing, the OECD's Mr Owens insists that tax evasion is a real problem, and a growing one: Ireland, which some consider to be a tax haven in its own right, last year recovered almost €1 billion in unreported tax revenues from banks in the Channel Islands. South Africa reckons it is losing 64 billion rand ($ 8.8 billion) a year to tax havens. Crackdowns on tax cheating in America, Britain, Canada and Australia have netted billions of dollars. Most of the cheats are individuals who cannot argue that global competition is driving them to it.

Mr Desai of Harvard is studying the effect of OFCs on the corporate governance of companies that use them. He reckons that they may facilitate corporate misdeeds, even unwittingly, because unscrupulous managers can use the often complex and opaque structures companies set up in tax havens for all sorts of dodgy doings. Mr Desai points out that Tyco and Parmalat both had thousands of subsidiaries offshore which its managers used not only to reduce their tax bills but also to loot the company. Enron's 700 companies in Cayman allowed its corrupt bosses to minimise taxes but also manufacture earnings. “This is the underappreciated real cost of OFCs, rather than lost tax revenues,” says Mr Desai.

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From The Economist print edition

Crooked OFCs have to be kept down, but good ones must be allowed to flourish

Gary Neil

SOMERSET MAUGHAM, a British novelist, once described Monaco, a tiny city-state on the Mediterranean coast that offers sun, secrecy and minimal taxes to its many super-rich residents, as “a sunny place for shady people”. That used to be true for many other OFCs as well. For some of them it still is. But things are changing, even in free-wheeling Monaco. Prince Albert, who took the throne in 2005, has vowed to rid the country of its reputation as a haven for tax cheats and crooked businessmen. In future, he said, his rule would be guided by “morality, honesty and ethics”.

The city-state, one of just a handful of jurisdictions still blacklisted by the OECD for its tax practices, is belatedly following other OFCs. Somewhat grudgingly, they have all been responding to international pressure that goes back to the early 1990s, when the G7 group of big, rich countries started to debate the risks of financial globalisation. This produced three separate but related international initiatives launched in the late 1990s.

The Financial Stability Forum (FSF) was put in charge of monitoring the systemic risks posed to the increasingly interlinked world financial system. The Financial Action Task Force (FATF) was set up to find a way to keep money-launderers out of the financial system (terrorist financing was added after the attacks of September 11th 2001). The OECD launched its “harmful-tax initiative” to get rid of unhealthy tax competition and prod jurisdictions into helping foreign tax authorities with their investigations.

OFCs were not the only target, but they received special scrutiny because the FSF and the FATF worried that they might prove the weakest link in the global financial system. The FSF paid particular attention to the banking system. International principles for banking regulation had already been set out by the Basel Accord in 1988. They were based, among other things, on the idea of “consolidated supervision” in which a bank's home supervisor took responsibility for monitoring the risks of the entire bank. This called for co-operation from host regulators. Many OFCs fell far short of this requirement.

The FATF drew up 40 standards for keeping money-launderers out of the financial system, including a ban on shell banks and a requirement that jurisdictions must know the true owners of all companies set up within their borders. Like the FSF, the FATF found that supervisors in OFCs often lacked expertise, good information and the mechanisms (and sometimes also the will) to exchange it.

Both bodies decided, separately, that the way to prod OFCs into action was to name and shame them. In 2000 the FSF blacklisted 42 OFCs and the FATF 23 “non-co-operative countries and territories”, including the Bahamas, Israel and Russia. Countries on these lists were often barred from doing business with banks and other financial institutions in the rich world or made subject to much more onerous disclosure requirements.

The IMF was put in charge of checking on the progress that OFCs and other big financial centres had made in meeting international standards. In a recent study it found that, on average, supervisory standards in OFCs were “superior to those of other jurisdictions”. OFCs met 80% of the standards on co-operation and disclosure related to bank and insurance regulation, though they still had further to go on anti-money-laundering measures. The FSF's worries are now largely about newer risks, such as the rapid growth of derivatives and hedge funds in OFCs.

By and large, good progress has been made. The FSF withdrew its list in 2005, though it set up a group

to continue monitoring OFCs. The FATF recently removed Myanmar, the last country on its blacklist.

Caring, sharing

But on the vexing issue of taxation, progress has been slow. The OECD's "harmful-tax" project, launched in 1996, covered some of the same ground as its sister initiatives. It aimed to get jurisdictions to collect better information and to share it with foreign tax authorities when necessary.

But four of the OECD's members—Switzerland, Belgium, Austria and Luxembourg—would not sign on to the project because they would have to give up their banking-secrecy rules, which do not allow the exchange of information about foreign tax evasion. The Bush administration also complained that the project would stifle tax competition, so the focus was narrowed to better information-gathering and exchange.

In 2000 the OECD blacklisted 35 tax havens. Only five of them still remain on the list: Andorra, Liberia, Liechtenstein, Marshall Islands and Monaco. Only two countries, Guatemala and Nauru, have no legal system for the exchange of tax information, although they are working on it.

But the real measure of success for the OECD project is progress on Tax Information Exchange Agreements (TIEAs)—bilateral agreements between tax havens and bigger countries to help each other on tax matters. The OECD sees these agreements as the answer to the problem of tax-dodging. America has signed over a dozen TIEAs, most of them with OFCs in its backyard, mainly because these tax havens depend so heavily on their big neighbour that they are bound to comply. But only three other TIEAs have gone through in the decade since the project was launched—although dozens are said to be in the works.

Europe has fared little better. In 1999 the EU launched a code of conduct aimed at "harmful" tax measures, using the same definition as the OECD's. The code was extended to EU members' dependencies, so it covered tax havens such as Jersey, Guernsey and Cayman. Jurisdictions dutifully abolished their "harmful" preferential tax regimes—but some simply extended the same low rates to everyone. Such moves technically comply with the code of conduct, but the EU is watching them warily.

The EU's savings directive, designed to squash tax evasion by individuals within Europe, took effect in 2005 after a decade of wrangling, but has proved something of a flop. The original plan was to get EU members and their dependencies automatically to exchange information on savings kept in their banks by citizens of other European countries. But once again the usual suspects—Luxembourg, Belgium, Austria and Switzerland (not an EU member but included in the savings directive)—would not budge. Under a compromise, countries could either exchange tax information or deduct a withholding tax on the offshore accounts of EU members and remit it in bulk to the investors' home tax authorities. Most member states chose to exchange information; most European tax havens went for the withholding tax.

So far, the countries that opted to withhold taxes have remitted a paltry €210m. The directive defined "savings" so narrowly that it was easy to find ways around it. The interest on bonds is subject to the directive, for instance, but dividends on shares, bond-like insurance products or income from derivatives are not.

Compared with the glacial progress on initiatives to counter tax avoidance, international projects on financial crime and bank regulation have done rather well. This is because most governments agree that money-laundering and financial meltdowns are best avoided. Many OFCs have co-operated in these initiatives, and the rest will have to come round—if only because they would lose their livelihoods if, say, a terrorist attack in America were financed through one of their banks.

The problem with getting agreement on tax matters is that the interests of big countries are not aligned—indeed there is vigorous competition on tax. This is why there is no international standard on tax evasion or tax competition along the lines of international standards on bank regulation or fighting financial crime. For example, Britain convinced the EU to exempt the eurodollar market, which thrives in London, from the definition of "savings" under the savings directive because it did not want to lose this business. Switzerland and Luxembourg fear—not without cause—that giving up banking secrecy would hit their private-banking business.

Where big countries do seem to be able to agree is in objecting to small tax havens that make life easy for cheats, particularly individuals. For multinational companies the picture is mixed. They are prolific

users of OFCs, and their home countries generally do little to stop them. The most straightforward way to do so would be to tighten up controlled-foreign-corporation (CFC) rules. Under these rules companies with subsidiaries in tax havens are taxed more heavily, making the use of OFCs less attractive. Every country has such rules, but detailed provisions vary.

If big countries were to make these rules more stringent, they would deprive tax havens of a lot of business—but they themselves would get hurt too as their companies lost competitiveness against foreign rivals. So they do a bit of sabre-rattling but mostly let their companies use tax havens to suit their needs.

Here to stay

The trouble with trying to curb the use of tax havens by companies is that tax systems are based on national boundaries, but multinational companies increasingly are not. Companies are in business to maximise profit, so they will base themselves in the lowest-cost and lowest-tax jurisdictions. Tinkering with transfer-pricing rules or CFC rules will not solve the problem.

Taxing individuals poses less of a dilemma. Individuals do not face global competition. They have to pay taxes in their home countries in return for the servies provided by government. If an individual feels his tax burden is unfair, he can vote for tax-cutting politicians or go to live in a less heavily taxed country—or, if he does not mind breaking the law, he can hide his money abroad.

Some experts believe that the only way of reconciling a system of national tax regimes with a global economy is to harmonise tax systems across borders. But this is not going to happen soon. Singapore, Hong Kong and other offshore jurisdictions are outside the scope of the OECD's tax project. They also show little interest in getting involved with the EU's efforts. Given the trouble the EU had introducing even a watered-down savings directive, broader tax co-ordination seems out of the question for now. Nor is it necessarily desirable, because a healthy dose of competition is good for the financial system.

The best bet is, first, for countries both onshore and offshore to exchange tax information and target cheats—individuals and corrupt companies seeking obscurity offshore—that harm the financial system.

Second, rich countries should look in the mirror. A recent World Bank study showed that cutting tax rates and simplifying tax systems can greatly reduce the incidence of tax evasion. Doing so would make tax havens less attractive.

But until and unless these things happen, OFCs are here to stay. That may be no bad thing. The small, unsuccessful ones are already being driven out. Those that remain should be monitored more closely. But the well-run, nimble ones will continue to thrive because they have something to offer in a globalised world.

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Diamonds

Changing facets

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Panos

An industry once dominated by a cartel is starting to look like any other

DIAMONDS are back on the big screen. The stones serenaded by Marilyn Monroe as a girl's best friend are now, however, portrayed by Hollywood as Africa's worst enemies. Leonardo DiCaprio may win an Academy Award for his performance in “Blood Diamond”, as a mercenary hunting for the precious rocks during the war in Sierra Leone in the 1990s. But in reality, the shape of the industry—which produces an estimated $13 billion of rough stones and over $62 billion of diamond jewellery—has greatly changed since then.

Most of this transformation is due to the fact that De Beers, the company that once controlled much of the supply of rough diamonds, has loosened its grip, and a host of smaller producers are emerging. Regulators in Europe and America and governments in Africa have also promoted change, and “blood” diamonds have almost disappeared. As a result, the diamond trade is starting to look more like any other ordinary industry.

The shift, says Gareth Penny, De Beers' managing director, has been “from a supply-controlled business to a demand-driven one.” In the early 1990s the diamond giant was producing 45% of the world's rough diamonds, but selling about 80% of the total supply from its London marketing outfit, regulating the market through the careful management of a large stockpile. But sitting on a big inventory was not good for financial returns. At the same time regulators in America and Europe were calling for more competition and stories abounded about atrocities committed by diamond-financed rebels in Africa.

After new management arrived in the late 1990s, De Beers changed tack. Its main trading outfit stopped buying diamonds on the open market. The company delisted in 2001 and is now owned by Anglo American, the Oppenheimer family and the government of Botswana. It has settled its long-standing antitrust dispute with American regulators. And it has promised the European Union that it will stop buying diamonds from ALROSA, the state-owned Russian firm that extracts 20% or so of global production, by 2009 in order to promote competition. Today, De Beers sells about 45% of all rough diamonds, and its share of production is about 40%.

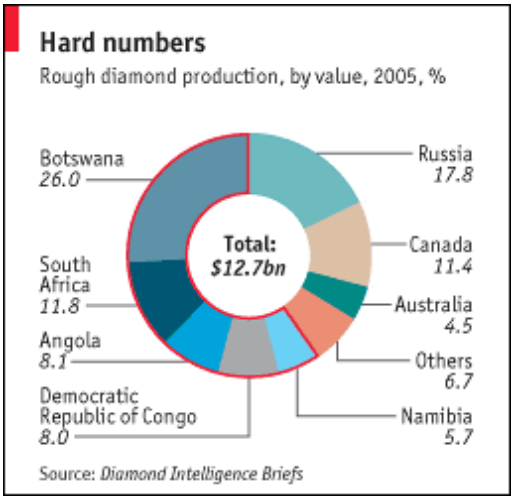
As the market becomes more dynamic, De Beers is investing heavily in exploration, developing four mines in Canada and South Africa and selling underperforming operations. The diamond giant has established a chain of jewellery shops in a joint venture with LVMH, a luxury-goods group. It now spends about $200m a year on marketing, which has helped to boost sales of diamonds, particularly in Asia. Marketing is also vital in persuading people to buy the real thing. Synthetic diamonds have captured 90% of the industrial market, but have made few inroads into jewellery, at least so far.

Smaller firms such as Kimberley Diamond Group, Trans Hex and Gem Diamonds are racing to fill the gap between large producers and exploration juniors. Petra Diamonds, another small firm, has just bought one of De Beers' South African mines. Petra is confident that it can make money from the loss-making mine, unburdened by De Beers' costs. It is also about to start producing in Sierra Leone, and is optimistic about its exploration in Angola, where it is working with BHP Billiton. The company expects to produce 500,000 carats by 2010, up from 175,000 carats last year. But this is still tiny next to the record 51m carats De Beers produced in 2006.

Meanwhile Lev Leviev, a secretive diamond tycoon, has been setting up cutting and polishing facilities in Africa, buying some rough stones direct from governments and moving into production, putting further pressure on De Beers. “Leviev has been a driving force behind the revolution at De Beers,” says Richard Chase of Ambrian Partners, an investment bank, though Mr Penny shrugs this off.

What is certain is that Africa, which produces 60% of the world's diamonds (see chart), wants to do more than just supply rough stones. “De Beers has failed to properly appraise the aspirations of African governments,” says Chaim Even-Zohar, a prominent diamond specialist. “Now it is payback time.” Gone will be the days when African diamonds were shipped to London to be sorted and aggregated in lots before being sold.

In January the firm agreed with Namibia's government that all diamonds produced by their joint venture would be sorted at home, and about $300m worth of gems, just under half the output, would also be sold locally. Last week De Beers, which has already sold 26% of its South African arm to a black-owned consortium, said it would merge its Namaqualand mine with a state-owned diamond firm to create a new independent local producer. And by 2009, all De Beers stones from around the world will be sent to a swanky glass building in Botswana's capital to be aggregated. All this shows that mineral resources need not always be a curse.



African producers are also keen to cut and polish their own diamonds, which adds 50% or so to the value of rough stones, and even move into the jewellery business. Although it remains a big trading hub, Antwerp is no longer the world's cutting and polishing centre, and Israel has suffered as well. Almost all diamonds are now cut and polished in India or China, but African producers hope to get a share of the business.

And what of blood diamonds? Today, says Alex Yearsley of Global Witness, a pressure group, they make up a tiny fraction of world production. But Mr DiCaprio's on-screen antics have raised awareness of the issue. Although it is a big step forward, the Kimberley process—a certification scheme set up in 2002 to ensure that diamonds are not paying for weapons—is not perfect, and dodgy diamonds can still find their way onto the market. De Beers says the film's release in America, just before the crucial Christmas season, did not dent jewellery sales. But more customers now want to know where their diamonds come from and want a guarantee that they are clean.

This is good news for those producers that can demonstrate the provenance of their stones. Canada has developed a certification scheme for its diamonds, and since 2004 De Beers has been selling some stones in Asia with its Forevermark, a microscopic engraving that guarantees their origin. Small producers, such as Petra Diamonds, are following suit.

Even so, Global Witness says the industry is not much more transparent than it was a few years ago. Smuggling is rife, especially in countries like Angola and the Democratic Republic of Congo, and illegal diamonds still find their way to rich countries. Some 1m informal miners pan the rivers of Africa for alluvial diamonds, often in appalling conditions. The Kimberley process was designed to stem the flow of conflict diamonds, says Willie Nagel, an international diamond trader who was instrumental in setting it up, but “conflict-free diamonds should not be confused with ethical diamonds.” Mining firms and voluntary groups are working to improve matters. Hollywood may not be looking to a Leonardo for its next portrayal of the industry—but it is by no means certain that it will be seeking a Marilyn either.

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Punitive damages

Smokescreen

Feb 22nd 2007
From The Economist print edition

America's Supreme Court curbs punitive awards, but ambiguity remains

TEN years ago Jesse Williams died of lung cancer at the age of 67 after smoking around three packets of Malboros a day for 42 years. His widow sued the manufacturer, Philip Morris, the world's biggest tobacco company. In 1999 a jury in Oregon awarded $821,000 in compensatory damages (later reduced to $521,000), but imposed a further punitive award of almost 100 times as much.

This week, in a ruling hailed as a blow against excessive punitive damages, America's Supreme Court rejected the original $79.5m payout to Mr Williams's widow. But the court disappointed business lobbyists by declining to lay down clear numerical limits to such awards.

In a 2003 case involving State Farm Mutual Automobile Insurance, the Supreme Court ruled that punitive damages should normally be capped at ten times the compensatory damages. Oregon's Supreme Court nevertheless decided last year to uphold the Jesse Williams award, pointing to Philip Morris's “extraordinarily reprehensible” conduct in deceiving the public about the dangers of smoking.

But in its five-four decision this week, the federal Supreme Court ruled it unconstitutional for a jury to award punitive damages to punish a defendant for injuries suffered by “strangers to the litigation” (in this case, other smokers). It nevertheless ruled that juries could consider such harm in determining the “reprehensibility” of the defendant's conduct—one of the factors used in setting the size of a punitive award.

Corporate America has long complained about swingeing punitive damages, unknown in the rest of the rich world. These, it says, are often arbitrary and encourage frivolous lawsuits brought by plaintiffs' lawyers on a contingency-fee basis, which allows them to pocket a large slice of the proceeds themselves. In one notorious case in 1994 a grandmother was awarded $2.9m after spilling a cup of scalding McDonald's coffee on herself. More recently, a jury in Florida awarded $104m to a teenage boy left in a vegetative state after being trapped underwater by the suction of a swimming pool's unprotected drain. But these are the exceptions. Half of all personal-injury awards, according to a recent study, are for less than $50,000, and only 12% are above $1m.

This week's ruling has been hailed by business leaders as a victory for corporate defendants. Most had nevertheless hoped for clearer guidance. The court said that judges will have to be vigilant in ensuring that jurors consider harm to others only in assessing reprehensibility, not in deciding the level of punitive damages. Many wonder how this will work in practice. The jury will have to be forced into an “intellectual straitjacket”, one law professor suggested. The issue is bound to be back before the Supreme Court before long.

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Pharmaceuticals

Knock it off

Feb 22nd 2007 | NEW YORK
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A row is brewing in America over generic drugs

CAN generic drugs harm the interests of consumers? It sounds absurd. After all, the arrival of generic competition typically leads to a sharp fall in the price of prescription drugs. America is so keen to encourage generics that the law grants 180 days of exclusivity to the first firm to win approval for a given new generic—a highly lucrative monopoly dangled as a carrot to lure more generics onto the market.

Yet America's Congress is now considering outlawing some forms of generic drugs. This month a bill was introduced in Congress that would ban the launch of “authorised generics” during the 180-day exclusivity period. This could completely upend the generics market, worth over $20 billion in America alone.

Authorised generics are controversial because they are promoted not by upstarts in India or Israel challenging a patent, but by the patent holder of the original drug. Since they are not new drugs, but are simply repackaged versions of branded drugs, they can slip through a loophole to compete against genuinely new generics, making a mockery of the 180-day rule.

Some branded manufacturers have set up their own in-house divisions to market authorised generics. Greenstone, a division of Pfizer, has launched authorised versions of Zoloft and several other blockbuster Pfizer drugs since 2003. This helps to soften the blow when drugs go off-patent, says Mehta Partners, a consultancy.

Other big firms have taken to licensing generic manufacturers to sell such pre-approved knock-offs. Merck, for example, recently authorised Dr Reddy's, an Indian generic firm, to sell cheap versions of its cholesterol-lowering blockbuster, Zocor. Michael McCaughan of Windhover, an industry publisher, reckons that such authorised generics mean that a generic firm loses “potentially half of the windfall that comes from an exclusive generic launch, an amount that could easily reach a billion dollars for a product like generic Zocor.”

The branded-drugs giants argue that the proposed new legislation is misguided. They point to a study by IMS Health, an industry research outfit, which suggests that authorised generics benefit consumers. IMS reckons that the entry of an authorised competitor into a new generics market leads to greater discounts relative to the branded drug's price. Rubbish, say generics firms. A study funded by the Generic Pharmaceuticals Association (GPhA) found that the branded drugs had higher prices in markets with authorised knock-offs, thus inflating the apparent discount. The GPhA says authorised generics hamper innovation by generics firms.

Who will prevail? The promotion of authorised generics has attracted unwelcome attention at a time when many branded drugs are about to go off-patent. That may help explain why, despite the drugs giants' legendary lobbying influence, the political tide appears to be turning against them. The Federal Trade Commission (FTC) is suspicious of authorised generics, and has opened an investigation into the matter. Congressional efforts to crack down on authorised generics appear to have strong support. And last week Senators Hillary Clinton and Chuck Schumer introduced an unrelated bill that would speed the arrival of generic versions of biotechnology drugs.

Even if the pharmaceutical giants win the battle over authorised generics, they may yet lose the war if the result is a broader public backlash. As David Balto, a former competition official at the FTC, observed wryly to *Drug Topics*, an industry newsletter: “This kind of thing is unique to Big Pharma. You don't see Apple coming up with a knock-off iPod.”

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Satellite radio

They cannot be Sirius

Feb 22nd 2007 | SAN FRANCISCO
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Regulators may oppose the merger of America's two satellite-radio firms

EVEN a cursory glance into a typical van pulling into the car park of an American mall reveals a bewildering amount of entertainment activity going on inside. Mum is likely to be talking on her mobile phone behind the wheel. Music will be playing from an iPod, or from a satellite or terrestrial radio station. The children in the back have their own iPods, mobile phones or games consoles, or are watching video on screens built into the seats in front. America's cars, boats and recreational vehicles are fast becoming entertainment centres that happen to move around.

It is therefore somewhat surprising that Kevin Martin, the chairman of the Federal Communications Commission (FCC), which regulates America's telecoms and media industries, responded negatively to news this week that America's two satellite-radio companies want to merge. Sirius, based in New York, and XM, based in Washington, DC, plan to unite in an exchange of shares that would leave each firm's shareholders with half of the new company, worth about $11 billion on the day of the announcement, February 19th. But first they need approval both from America's Department of Justice, which rules on antitrust matters, and from the FCC, which looks out for the more arbitrary “public interest”. Mr Martin said that the “hurdle” would be “high” for Sirius and XM to prove that their union would not limit consumer choice or affordability.

WireImage

Now available at half price?

In fairness, Mr Martin can point to an FCC rule that specifically bars Sirius and XM from merging. But that rule was written a decade ago, when neither company had begun its service, and years before iPods, podcasts and other neologisms had battled their way into the English vocabulary. Sirius and XM have since launched their satellites, struck deals with carmakers to build receivers into their vehicles and signed exorbitant contracts to license content—most notoriously with Howard Stern (pictured), the country's most sexually explicit “shock jock”, whom Sirius is paying $500m over the course of five years. Such deals, and the proposition of music, sports and news uninterrupted by advertising breaks, have enabled both firms to attract plenty of paying customers—XM has 7.6m, Sirius 6m—although forecasts have fallen in the past year.

Not surprisingly in a new business where most costs are fixed rather than variable, both firms still make losses. But this cost structure, rather than a desire to increase market power, is what makes the deal attractive, says Craig Moffett of Sanford C. Bernstein, a broker. By teaming up, the two firms can cut their fixed costs, the biggest of which is content. A merger “would cut the cost of Howard Stern in half,” says Mr Moffett, and so move the combined firm closer to profit. It is “unlikely”, he contends, that the merged firm would raise prices beyond the $12.95 per month that both Sirius and XM now charge subscribers.

But what about choice? Counter-intuitively, a merger would lead to more of it, say XM and Sirius, since it would allow them to drop channels that duplicate each other and to replace them with a wider range of niche channels. The FCC, however, will also be on the receiving end of an opposing view, delivered loudly from the politically powerful National Association of Broadcasters (NAB), an industry lobby with members such as Clear Channel, the country's largest terrestrial radio broadcaster. The NAB is expected to argue that the newly unified satellite outfit would put local programming on some of its new niche channels, which would violate today's rules and compete with terrestrial radio stations. This would be an odd argument in some ways, since the violation would consist of increasing consumer choice, not limiting it.

In the past Mr Martin, a Republican, has been sympathetic to the NAB. Of the other four commissioners,

two are Democrats who tend to be wary of “media consolidation” and two are Republicans who may be more inclined to take a friendly view of the merger. There is, in short, a lot of politics to contend with, which makes a sensible outcome far from assured.

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Wireless internet

WhyMax?

Feb 22nd 2007
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A much-hyped wireless technology is about to be put to the test

FOR the 60,000 people attending at 3GSM, the wireless industry's annual trade show that took place in Barcelona last week, WiMax was everywhere: on huge banners, on the lips of executives and on products in display cases. Everywhere, that is, except in the real world. The vaunted new wireless technology promises to combine the speed of broadband internet access with the ubiquity of mobile phones. Even as mobile operators start to upgrade their networks to the latest enhanced third-generation (3G) equipment, WiMax boosters say their technology is superior. Now that WiMax networks are starting to pop up around the world, the industry will soon find out if they are right.

A survey by Pyramid Research, a consultancy, found that 78% of telecoms operators are considering an investment in WiMax this year. More than 200 operators around the world are preparing to deploy WiMax or have begun trials, says TeleGeography, a market-research firm. The few previous WiMax deployments provided a poor test, since they used an early variant of the technology that works only with stationary devices; but now “mobile WiMax” standards have been agreed and the first products will soon be available.

Sprint Nextel, a big American wireless operator, plans to spend $1 billion on the first stage of a $3 billion national WiMax network, which will be up and running by the end of the year. Two start-up operators, Clearwire and NextWave, are also using the technology. Intel, the world's biggest chipmaker, plans to have WiMax chips for laptop computers ready this year. And regulators in Europe are considering allowing radio spectrum intended for 3G to be used for WiMax as well.

Taken together, the prospects for WiMax have never seemed brighter. On the surface at least, the excitement seems justified: WiMax offers higher download speeds than 3G technologies and, according to industry lore, does so at one-tenth of the cost. Like Wi-Fi, the popular wireless system found in homes, airports and cafés, WiMax can use unlicensed (ie, free) spectrum, making it less expensive to deploy. Its supporters believe it will compete with mobile, broadband over telephone lines and cable technologies in rich countries, and will make possible far more widespread internet access in poor ones.

But the economics of WiMax do not look as promising as the technology. In developed countries, it will struggle to compete with telephone or cable broadband on cost, except in remote areas. It will also be difficult for WiMax to compete with mobile-phone networks, given that operators have already signed up millions of customers, have strong brands and can upgrade their existing networks to provide roughly the same service, notes Alastair Brydon of Analysys, a consultancy. And in poor countries, the high initial cost of WiMax devices compared with mobile phones will make it a hard sell, he says.

Some of the claims made about WiMax are more myth than reality, says Mike Roberts of Informa Telecoms & Media, a market-research firm. Although it offers faster speeds than mobile networks, it consumes more battery power and requires more base stations to achieve coverage and penetrate building walls. Most networks will need licensed (ie, paid-for) spectrum to ensure good-quality service. The “one-tenth of the cost” estimate is based on rosy assumptions. And the latest enhancements of 3G technology, such as HSDPA and EV-DO, are improving fast. In a recent report Pyramid Research described the claims made for WiMax as “largely speculative and desperately theoretical”.

So if the business case for WiMax looks fragile, what explains its popularity? Two things: the desire of equipment-makers who have not done well out of 3G to make up for it with the move towards 4G technology; and the computer industry's aspiration to break into wireless technology. WiMax's big supporters include Motorola, Nortel, Samsung, NEC and Fujitsu—none of which is a big hitter in 3G network gear. The biggest backer of WiMax is Intel, which hopes to extend its dominance in computer chips into wireless devices.

WiMax faces a stiff battle with enhanced 3G systems. But there need not be a single winner. The technologies will co-exist, says Carlton O'Neal of Alvarion, a WiMax equipment-maker. Mobile handsets could support both technologies, albeit at higher cost, says Mr Brydon. The beneficiaries of this wireless-broadband battle could be the operators, who can play one side off against the other to cut costs. A little competition can go a long way.

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Mediterranean shipping

Rough passage

Feb 22nd 2007 | GIOIA TAURO
From The Economist print edition

Labour problems and the Mafia cloud Italy's largest container port

THE *Columbine Maersk*, a large container ship, was due to call at Gioia Tauro in Calabria on February 9th on its way from Tanjung Pelepas in Malaysia to Algeciras in southern Spain. But the Italian port was paralysed by a three-day strike, so the ship called instead at Valencia. Container vessels on which much of the world's trade depends have tight schedules fixed months in advance, and such disruptions are costly to the businesses affected. In the short term the Calabrian port lost around €150,000 ($195,000) of revenue from the diversion of the *Columbine Maersk*. But the ultimate damage may be far greater. "Shipping lines require reliable ports and will sail their ships elsewhere if a port is not reliable," says Cecilia Eckelmann Battistello, managing director of Contship Italia, Gioia Tauro's operator.

Gioia Tauro acts as a hub for the distribution of containers throughout the Mediterranean and the Black Sea. The arrival of a large "mother" vessel may generate calls by up to 10 "feeder" vessels. Before the labour difficulties, which began in December, the port was a rare success in a region where usually the only group to thrive is the *'Ndrangheta*, the region's Mafia. "Calabria has nothing and Gioia Tauro would be a wasteland without the port," says Ms Eckelmann Battistello. The town's unhappy past includes an aborted steelworks and a large power station, abandoned because of Mafia meddling.

The *'Ndrangheta* tried to extort $1.50 for every container handled when the port began operating in 1995. But that demand was overcome, the port thrived and Gioia Tauro has vied with Algeciras in recent years to be the Mediterranean's biggest transhipment hub. The strike will improve the Spanish port's standing and boost other Mediterranean ports.

Yet Gioia Tauro enjoys a big natural advantage. It sits virtually in the centre of the Mediterranean and the container port, unlike those on the islands of Malta and Sardinia, enjoys direct rail links north into the expanding markets in the heart of Europe. "The traditional way into Central Europe is through Hamburg and from there by rail," says Tim Halhead, Gioia Tauro's operations director. Transhipment via Gioia Tauro can save a week, he says, which is not to be sniffed at when delivering, say, a container full of laptop computers. Every week 15 container trains run to northern Italy.

The problems at Gioia Tauro come at a critical time, as a new class of giant container ships enters service. Dredging and other improvements are under way at Gioia Tauro to provide for these new vessels. Contship Italia hopes to create an extra 1,800 jobs by 2015. But all this has been put at risk by the strike, the cause of which remains murky.

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Chinese cars

One to watch

Feb 22nd 2007 | SHANGHAI
From The Economist print edition

The world's big carmakers have unwittingly created a new Chinese rival

THE new Roewe 750 saloon, which goes on sale in China this month, would appear to be a textbook example of why the world's big carmakers have nothing to fear so far from their Chinese rivals. Like many Chinese-built cars, it is based on a Western design—in this case the Rover 75, the last model to be introduced by Britain's now defunct MG Rover. That hardly inspires confidence. And given the poor reputation of Chinese cars, which tend to be cheap rather than reliable, it is not surprising that the new car has failed to cause much of a stir within the industry.

AP

Target market

But the Roewe, launched by SAIC—a state-owned carmaker that has joint ventures with General Motors and Volkswagen to make Chinese versions of their cars—is not the cheap knock-off its name implies. Unlike other Chinese firms, SAIC has not “borrowed” technology, components or designs for its new car. It has bought them or developed them in-house.

The original Rover 75 design has been substantially improved by engineers and designers in Britain and Italy and at Ssangyong, SAIC's South Korean subsidiary. And MG Rover's ultimate collapse notwithstanding, the 75 was actually a good car. Developed by BMW, which owned MG Rover for a while, and with an excellent engine designed by Honda, the 75 has a fine pedigree. SAIC has spent two years changing the styling, upgrading the chassis and designing a new interior.

To manage its independent production division, SAIC hired Phil Murtaugh, who previously ran GM's Chinese operation. He has been able to call upon the 5,000 engineering staff who work for subsidiary suppliers to the GM and VW joint ventures. The joint ventures also mean that SAIC already has a strong relationship with car dealers throughout China.

SAIC has the capacity to manufacture 50,000 cars a year, but there are no initial production goals, sales targets or export plans. The emphasis is on getting the product right and making sure local customers are satisfied—a concept unknown to domestic rivals. The quality and safety expectations of Chinese consumers are evolving quickly, Mr Murtaugh believes. And a strategy to maximise sales now, based on very low prices, would be counterproductive in the long term. SAIC's actions in the coming year will determine its reputation for years to come, he thinks.

SAIC wants to compete with the big foreign firms in the mid- to high-end market, selling to Chinese urban professionals between the ages of 26 and 45. This is a group where prosperity seems to be rapidly

expanding, so there is a chance to become its preferred carmaker. SAIC can afford its patient entry strategy because despite being a new company in many ways, it has no shortage of resources. Being state-owned, it can theoretically call on the government if it needs cash—which it does not. Its share of the joint ventures with GM and VW was enough to place it in the Fortune 500 back in 2004.

Assuming the launch of the Roewe 750 goes well, SAIC has plans of staggering, possibly foolhardy, ambition. By 2010—not a long way off in the car business—it intends to churn out 30 different models on five different platforms, a number that would rival established competitors around the world. This will not be easy. As Mr Murtaugh freely admits, engineering talent is thin on the ground in China, retaining staff is challenging and the complexity of launching so many products in such a short time would stretch even the world's best carmakers.

But doubt is nothing new to the Chinese car industry. Back in 1994 the Chinese government announced a plan to develop a stand-alone industry to general disbelief. It is surprising how far China's carmakers have since come. Chinese cars still have a poor reputation, but the Roewe could prove to be the first car to buck the trend.

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Face value

Queen of Madison Avenue

Feb 22nd 2007
From The Economist print edition

Shelly Lazarus of Ogilvy & Mather explains how advertising has changed during her long career—and how it hasn't

Mark Schafer

FOR the advertising industry, the Academy Awards ceremony on February 25th is “the Super Bowl for women”. It is the second-most-watched television show of the year in America after the annual American-football championship game, and television-advertising slots are priced accordingly. One of the advertisements that will be shown this year will be a 30-second spot for Dove Cream Oil body wash, a new product being launched by Unilever, an Anglo-Dutch consumer-goods giant. The company is screening the winning entry in an online contest in which consumers were invited to create their own advertisements. This follows on from Dove's quirky and award-winning campaign that featured ordinary-looking women and departed from conventional notions of beauty.

The spot captures something of the spirit of advertising today, with its combination of old and new media, “user-generated” content and an effort to engage the consumer rather than simply push a product. The driving force behind the campaign is not some young hotshot, but Shelly Lazarus, the 60-year-old chief executive and chairman of Ogilvy & Mather, one of the world's biggest advertising agencies. It is an illustration of how a 35-year career demands an ability to move with the times, without losing sight of a consistent underlying discipline.

The change is what is immediately apparent. “When I started in the business, television ads and three print ads were enough to advertise a brand,” says Mrs Lazarus. Advertising was a straightforward business: agencies had to devise a good idea for an ad and then choose the right publication or broadcast slot in order to catch consumers' attention. Today advertising is far more complex, thanks to technological advances, social shifts and the far greater sophistication of both advertisers and audiences. Modern consumers demand to be wooed, not berated. “We have gone from intrusion into consumers' lives to extending an invitation to them,” says Mrs Lazarus.

Ogilvy's past campaigns for Dove are good examples of this latest approach, starting with the “Campaign for Real Beauty”, launched in 2004, which set out to banish stereotypes and spark discussions about beauty. It became one of the most popular campaigns of recent years and won numerous awards. Last year Ogilvy persuaded Unilever to launch the Dove “self-esteem fund”, a worldwide campaign to persuade girls and young women to embrace more positive images of themselves. “Only 2% of women in the world think they are beautiful,” says Mrs Lazarus. User-generated content is just the latest trend in advertisers' efforts to establish closer contact with consumers, and with women in particular. About 70% of all decisions to buy something are made by women, according to industry lore. “The consumer isn't a moron—she is your wife,” as David Ogilvy, who founded the firm in 1948, liked to say.

Mrs Lazarus started working at Ogilvy & Mather in 1971 and has been there ever since. In that time the industry has consolidated and new forms of media have proliferated. Ogilvy & Mather was swallowed in 1989 by WPP, a British advertising giant, in a hostile takeover. (Today adland is dominated by four giants—America's Omnicom and Interpublic, Britain's WPP and France's Publicis.) The takeover caused an exodus of executives and blue-chip clients including American Express, which withdrew nearly all its business. Mrs Lazarus stayed on board and helped to win back clients. “Staying with the brand” is one of her guiding principles. It also led to one of her biggest successes: when Lou Gerstner, then boss of Amex, and Abby Kohnstamm, his marketing director, moved to IBM in 1994 they transferred IBM's $500m business to Ogilvy.

In response to the rise of the internet and other new media, Mrs Lazarus decided to bring together previously separate creative departments in many Ogilvy offices across the world. The idea was to offer clients what she grandly calls “360 Degree Brand Stewardship”. Internet types sit together with television, print, outdoor-advertising, direct-marketing and public-relations specialists. This helps them dream up ideas that work across all types of media, rather than devising separate campaigns for each one. Coming up with an “integrated idea” is also handy when Ogilvy presents a new campaign to a company boss. Chief executives are now more involved with their companies' brands than they were when she began her career, says Mrs Lazarus. They realise the importance of reputation and image, and want their companies to be seen as good corporate citizens—all of which requires a new approach to advertising, she says.

Plus ça change...

In spite of all these many shifts Mrs Lazarus thinks her job is in some ways not so different from when she started. Interactive, direct and other forms of non-traditional advertising accounted for more than half of Ogilvy's revenue last year compared with about 15% ten years ago. But what you still need is a great idea, she says. Another constant throughout her career has been her reluctance to pitch for business. It costs five or six times as much to acquire a new customer as it does to retain an existing one, so she aims to attract new clients through the quality of her work for others. (Ogilvy made an exception when it pitched, unsuccessfully, for Wal-Mart's advertising business last year. Mrs Lazarus says she does not regret the decision to break her usual rule.)

Mrs Lazarus has given some thought to her succession. She says she believes in running her company in a collegial way and has groomed several people who could take over as chief executive. Some are betting on Brian Fetherstonhaugh, head of the company's direct-marketing branch, a job also held by Mrs Lazarus in the course of her career. The ground rules of direct marketing have not really changed in all these years, says Mrs Lazarus. Nor have the principles of good advertising.

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Germany's car industry

The big-car problem

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From The Economist print edition

Germany produces some of the fastest and most luxurious cars in the world, but is that yesterday's game?

EARLIER this month Germany's carmakers were hit by new emission limits proposed by the European Commission. There were howls of protest, not least from Angela Merkel, the German chancellor. So the proposed ceiling was raised a little, to 130 grams of CO_2 per kilometre to be met by 2012. This still left the makers of many of the world's most prestigious cars with the most work: in the European Union only six German-made models meet the target, but 34 of those made by competitors do. Moreover, of all the cars on sale in Germany which pump out more than 200g of CO_2 per kilometre, most are German.

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This is not a happy state of affairs for a country that likes to lead the way on the environment. Nor does it bode well for Germany's biggest industry, which employs one in seven of the country's manufacturing workforce. Germany's carmakers should benefit from spreading their escalating costs of research and development across a greater volume of vehicles. But attempts to drive into mass markets have failed, with BMW's disastrous takeover of Britain's Rover Group and DaimlerChrysler's marriage now facing divorce.

For the time being, life still looks rosy. Volkswagen this week announced a 52% increase in operating profits for 2006. Mercedes, the car division of DaimlerChrysler, has bounced back from a couple of bad years. Sales of Porsches and BMWs seem almost insensitive to the price of petrol. The German stockmarket barely flinched at the new CO_2 standards.

Yet Germany's carmakers are less well-placed for the future than are other European producers, let alone the Japanese. German cars may well continue to dominate the performance parts of the luxury market—after all they are crammed with state-of-the-art technology. But buyers' tastes are changing and they have increasing qualms about the environment. This shift in the market is what has hit Chrysler's sales in America, because it is highly dependent on fuel-thirsty sport-utility vehicles (SUVs) and pick-up trucks.

And in premium carmaking, over-engineering—a familiar German vice—is becoming increasingly costly. Talk to a boffin at DaimlerChrysler or Continental, a big automotive supplier, and he will tell you proudly of the ever-increasing sophistication of cars' electronics: sensors that read the road-surface; adaptive cruise control, which responds to other cars; vehicle-to-vehicle internet communication, and more.

Premium cars are the ones that pioneer new technology, they say. Of Germany's big three, Mercedes and BMW have always been premium brands. Now they have been joined by Audi, a division of VW. Porsche is more of a specialist sports manufacturer. All four producers thrive in a domestic market where almost one out of every three cars sold is a premium model. This compares with little more than one in ten cars sold in America. German producers might hope the markets in other countries will continue to become more like their own, but the chances of that happening look increasingly slim—if only because the quest for engineering excellence, greater power, better safety and ever more efficient engines has pushed up costs.

More than any other nation, Germans are obsessed by the car: it was invented in their country. Little can match the elegance of the early Horch convertibles, forerunners of today's Audis; the presence of a Maybach (pictured above)—a brand revived by Daimler—or the acceleration of a hot Porsche 911. Combine history with flair and the union is complete. Cars shape German society as much as German engineering has shaped the car. Behind the wheel, mild and sociable family men become tyrannical zealots, intolerant of sloppy driving and nonchalant at motoring along at 200kph (125mph). Those German autobahns, unencumbered by anything so dull as a speed limit, are a God-given proving-ground for ever faster, more powerful vehicles. Could Porsche or BMW have evolved in a land where you are fined if you drive faster than 55mph?

The national obsession has allowed Ferdinand Piëch, grandson of Ferdinand Porsche, the begetter of the Volkswagen and Porsche marques, to build an empire based more on passion than common sense. In the 1990s, as chief executive of VW, he bought Bentley, a luxury British carmaker, and Bugatti and Lamborghini, a pair of Italian racing-car manufacturers. He backed the development of the Phaeton, a luxury saloon, in an attempt to ennoble even the VW brand. Mr Piëch, chairman of VW since 2002, even unveiled the Veyron, a 1,000-horsepower monster capable of some 400kph.

All this has been an expensive sideshow for the VW group, Europe's biggest carmaker with around 19% of the total market. But Mr Piëch, whose family along with their Porsche relations own all the voting rights of Porsche and recently raised Porsche's stake in VW to 27.4%, is powerful enough to indulge his passion.

AP

Piëch, the empire builder

Germany's other auto bosses, Dieter Zetsche at DaimlerChrysler, Wendelin Wiedeking, who runs Porsche, and Norbert Reithofer at BMW, have their feet a little closer to the ground. But, however solid and sophisticated the engineering of their products, it is the emotion of driving the marque that really commands the premium. Can that emotion survive in a world in which drivers face more restrictions and greater awareness of the damage they may be doing to the environment?

Premium carmakers have tended to assume a certain level of price-insensitivity among their clientele. But a new sensitivity is emerging. It could be from tax incentives designed to steer buyers away from emissions-heavy cars, from other government and municipal policies, and from changing consumer sentiment.

London has just extended the area of its traffic-congestion charge, which exempts environmentally friendly vehicles. Richmond, a London borough, plans to set the cost of resident-parking permits by the size of a car's engine. In Germany the federal government is proposing a car tax based on the level of its emissions. Such attempts to influence consumer behaviour are likely to increase. The VDA, the German carmakers' association, has applauded the move to tax CO_2 emissions rather than engine capacity.

Peter Fuss, an automotive expert at Ernst & Young, a consulting firm, is confident that German carmakers can not only adapt to these new challenges, but thrive on them. They may have been slow, for example, to see the need to develop hybrid cars—which combine electric and internal-combustion engines for cleaner driving—“but they will quickly catch up,” he says. The strength of German carmakers comes from a huge network of suppliers, combined with the research departments of universities, with which they work closely on new technology. “It's a great chance for Germany as a centre of excellence,” Mr Fuss adds. American carmakers, by comparison, have huge problems with their suppliers, he believes.

Jürgen Pieper, a car-industry analyst at Metzler, an investment bank, sees the problem as purely one of technology, which will be solved. Even if it is not solved in time for the 2012 deadline, companies can probably get by at the premium end of the market simply by paying fines, he says. Porsche and BMW are happily doing this in America, at the cost of millions of dollars a year, for exceeding average fuel-economy standards. The stockmarket, which seems to take the pragmatic view that carmakers will get by on

emission standards, is more cheered by the possibility that Daimler may free itself from its loss-making Chrysler division, which Mr Pieper values at zero.

Despite that show of confidence, German car firms do not have much of a road map for an alternative to the fossil-fuel engine. BMW, General Motors (GM) and Honda are working on a joint project for the hydrogen tanks required to feed fuel-cell engines. BMW, DaimlerChrysler and GM have teamed up on a hybrid drive. BMW has developed a totally clean car, the Hydrogen 7. Based on its “7 series”, this can reach 230kph and travel 200km on a single tank of fuel. Unfortunately, only five filling stations in Germany can provide the super-cooled liquid hydrogen the car needs, so it must run on petrol too. It has other drawbacks, including that all the fuel in the tank will evaporate if it is not used for nine days. “The hydrogen car is 20 to 25 years away,” admitted Mr Reithofer, BMW's chief executive, in a recent interview. Even that may be optimistic.

DaimlerChrysler and Audi are perhaps the world leaders in clean-diesel technology. DaimlerChrysler claims that its Bluetec fuel, available in the United States, makes its diesel engines as clean and efficient as a hybrid. Clean diesel, made from fossil fuel or from bio sources, is a seductive answer to environmental concerns. It is so efficient, compared with almost any other power source, that it is likely to be used, at least in long-distance lorries, for decades to come. This is important for DaimlerChrysler, one of the world's biggest lorry-makers, and may have had much to do with Mr Piëch's recent attempts to forge a triple alliance between MAN of Germany, Scania of Sweden and VW's own lorry-making division.

We don't do frugal

What German carmakers have resisted making is a cheap and cheerful car. In recent years, VW attempted it with the Lupo. But this was under-powered and ceased production because demand was so low. Despite being Europe's biggest carmaker, the company has only 6.3% of the low-cost segment in western Europe, according to a study by Roland Berger, a consultant.

There is growing demand for budget cars. The Logan, built in Romania by Dacia, a subsidiary of Renault, is selling unexpectedly well. Now Skoda, a VW subsidiary, is planning to build a new low-cost car at its plant in Bratislava.

DaimlerChrysler had a salutary experience with the Smart, a low-emission runabout. The car is small but sophisticated. It was initially sold and serviced separately from Mercedes and unsurprisingly failed to make an impact on dealers or the public. Now Smart sales and service have been integrated with Mercedes and things are starting to go better. But with a price tag of around€9,500 ($12,470), it is less a peoples' car than a yuppies' one.

One thing hindering change could be German carmakers' fresh memory of surviving a downturn a few years back by sticking to their business model and driving down costs. That helped them maintain their exports—some 64% of which go to other west European countries.

But now alarm bells should be ringing. With the exception of Mercedes and France's Renault, the average age of models proffered by the big European carmakers is increasing—in other words new models are in decline relative to sales volume, according to research by Mr Pieper at Metzler. Whereas German carmakers have proved brilliant at re-engineering and refining their existing platforms, they seldom show the flair associated with something truly innovative.

The apparent complacency of Mr Reithofer at BMW, in a recent interview, says it all: he attributes BMW's growth to increased sales volume, cost cutting and greater efficiency. “We're admired by Toyota for our production flexibility,” he said. “We are able to change specifications to a vehicle just six days before it is produced.” He said little about new concepts that will take BMW out of the gas-guzzling end of the market. The company's answer to the American public's recoil from buying large SUVs, such as its X5, has been to produce the X3, which is smaller but not much more environmentally friendly

If the German passion for premium cars also ebbs, will any German carmaker—besides, perhaps VW's Skoda in Bratislava—be in a position to compete?

Driving east

Only VW, among the German carmakers, has taken advantage of the lower costs offered by assembling

cars in central Europe. VW builds Audis, Seats and three types of Volkswagen at its plant in Slovakia. It also builds various cars in Bosnia, the Czech Republic, Hungary and Poland. Opel, a German subsidiary of GM, builds cars in Hungary and Poland.

Low wages, combined with proximity to the big west European markets, help reduce production costs. That is despite the extra cost of logistics—two or three times higher than for cars built in western Europe, says a study by the Fraunhofer group at Vienna's University of Technology—and an inevitable loss of quality. Fearing just such a loss of quality, BMW and Porsche have ventured only as far as placing factories in Leipzig in the former East Germany. (Although Porsche's Cayenne SUV is made on the same platform as VW's Touareg, which is assembled in Slovakia; and BMW builds diesel engines in Austria.) Mercedes is nowhere to be seen east of the river Oder.

AP

Zetsche tests the Chinese market

BMW and DaimlerChrysler have a relative price advantage, says Wilfried Sihn, head of the Vienna group, “But if you go down-market with, say, the Smart or the Mercedes A Class, costs begin to tell.” He predicts that BMW and Mercedes will have to go east, but probably to Romania or Ukraine, since the cost advantage of locating nearer home is eroding. The central European market is not as big potentially as India or China, says Mr Sihn, “but the purchasing-power today is greater.”

But BMW and Mercedes will be late. Toyota—seen as their most dangerous competitor—is already making cars in Kolin, in the Czech Republic; moreover Peugeots and Citroëns are being assembled by agreement at the same plant. Hyundai, Kia and Daewoo, three South Korean producers, Suzuki and Subaru of Japan, and Lancia and Fiat of Italy are already dotted about the region. Then there is Renault/Nissan in Romania and Slovenia.

The reality is that, of the roughly 15,000 components that go into the average car made in central Europe, 80% are still imported from the west. That will change in time, predicts Mr Sihn: “It's a well-kept secret that research and development lives from production,” he says, “so it will gradually migrate east too.”

Mr Reithofer at BMW will not accept a future in which it is too expensive to make cars competitively in Germany. “Can you imagine an industrial country like Germany in 15 or 20 years without such production?” he said recently. “I hate to think what would happen here if we lost our production base.”

Mr Sihn, despite his dire warnings, is also confident that somehow Germany will remain a manufacturer of automobiles. There will, after all, always be customers prepared to pay more for exclusivity, performance and luxury—even in developing markets like China and India. How big that part of the market will be remains to be seen. German carmakers should not be written off and they could yet spring some surprises. But the trend is turning against them.

If western Europe wants to stay an automobile producer, concluded a recent Ernst & Young study, “it must redouble its efforts in education and research.” Production of components and final assembly will migrate elsewhere, according to its opinion poll of German carmakers and suppliers. But branding and marketing, engineering and design have a chance of staying in Germany and even growing there, said an overwhelming majority of respondents. Germany is the world champion in taking out automotive patents: its car firms spend €16 billion a year on research and development, says Bernd Gottschalk, president of the VDA.

It would be easier to pay for automotive innovations if the costs could be spread across mass-market cars, too. For instance, Daimler and Porsche were among the first to fit airbags, and these are now offered on

most cars, big and small. But German carmakers may struggle to enter mass markets. Buying Chrysler was not the answer for Daimler. Along with BMW, it has tried to popularise its premium technology with some smaller, more economy-minded vehicles, like the Mercedes “A” class or BMW's Mini. But these are not “no frills” cheap cars.

The biggest threat to the German motor industry could be a disruptive technology, such as a totally new source of power (unlikely) or (more likely) the gradual decoupling of personal mobility from emotion. Judging by the aspirations of millions of Indians and Chinese for the personal mobility offered by the motor car in their countries, that may not happen for years in emerging markets. But in industrialised countries, where the infrastructure allows it, car-driving is increasingly being integrated with traffic management, safety aids and environmental protection.

Even car-sharing, once rubbished when it was proposed by Eckard Minx, DaimlerChrysler's own futurist who runs a think-tank in Berlin, no longer seems an absurd idea. But it, too, is a subversive one, since it undermines the passion that has sprung from individual freedom and mobility ever since the first rider climbed onto a horse. In the long run changing attitudes could even undermine the market for beautifully made German cars.

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Japanese interest rates

A hiker's guide to Japan

Feb 22nd 2007 | TOKYO
From The Economist print edition

The central bank's governor finally gets his way

Satoshi Kambayashi

Get article background

IF AT first you don't succeed, try, try again. It was third time lucky for Toshihiko Fukui, the governor of the Bank of Japan (BoJ), in his bid to raise interest rates. In December and then again in January, he had failed to persuade enough of the BoJ's nine-member monetary-policy board to vote for an increase. But on February 21st, after hours of haggling with fellow members concerned about the economy's fragile recovery, he got his reward at last. The vote was eight to one in favour of raising the bank's benchmark rate by a quarter of a percentage point, to 0.5%. It has not been that high for more than eight years.

Japan's rates are still the skimpiest in the rich world, a fact not lost on international investors. They have been borrowing heavily in yen and putting the proceeds into more remunerative assets, such as antipodean bonds (see article). This carry trade, as it is called, has cheapened Japan's currency, much to the chagrin of American carmakers and European policymakers. A quarter-point rise will do little to deter the traders, but it might appease Japan's foreign critics.

This international carry-on is, however, the last thing on Mr Fukui's mind. This week was his final chance to sneak a rate rise past politicians in his own country, before a season of heavy politicking begins. The government, led by Shinzo Abe, the prime minister, faces a big round of local elections in April and a fiercely contested Upper House election scheduled for July. It did not welcome this week's decision, but it would have fought much harder against a spring hike that would have embarrassed its candidates on the stump.

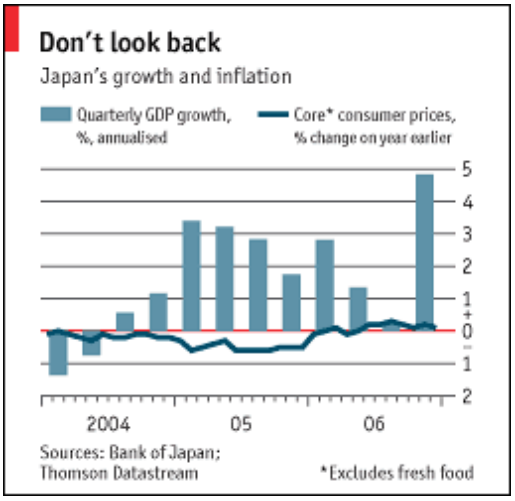
As it was, Mr Abe's hatchet-men had to be restrained from the same heavy-handed methods that prevented a rate rise last time. Chastened by the global reaction, his ruling Liberal Democratic Party realised it had overstepped the mark by bullying the central bank so overtly. It will take the BoJ a long time to recover its international credibility as an independent custodian of Japanese monetary policy.

Amid all of this political teeth-gnashing, Mr Fukui has been anxious to wean Japan off its addiction to cheap money. He does not want to repeat the bank's mistakes of the 1980s, when its lax monetary policy created a bubble economy. The collapse of that bubble brought the country's banking system to its knees and condemned Japan to 15 years of deflation. To prevent anything like that happening again, Mr Fukui has insisted that the bank adopt a more forward-looking approach, instead of having to react hastily to

news from the market.

A year ago the BoJ declared deflation dead and ended its five-year experiment with “quantitative easing”, which involved flooding the market with excess liquidity. Confident that the worst was behind it, the bank raised rates last July from zero to 0.25%. Ever since, the governor has been itching to raise them again—in order to return a measure of normality to monetary affairs. In Japan “normality” means steering interest rates gradually to somewhere around 2%.

The BoJ has been held back until now by the choppy state of the Japanese economy. After a particularly bleak third quarter, when it eked out annualised growth of just 0.3%, the fourth-quarter numbers announced last week came as welcome relief. For the three months to December, the economy grew at an annual rate of 4.8%, its fastest pace in three years. Much of the gain was thanks to stronger personal spending, which was up by an annualised 1.1%. This was mainly a rebound from the previous quarter, when spending fell by much the same amount. But it still cheered the BoJ no end.



The bank is counting on consumption, which accounts for 55% of Japanese GDP, to become the locomotive of the economy. Households are certainly spending what they have. According to the OECD, Japan's household saving rate has fallen by over eight percentage points since 1998, a deeper plunge than America's. The country's households now fail to dispose of just 2.9% of their disposable income.

Unfortunately, that income is not yet rising as quickly as it might. The weak yen and low interest rates have helped companies make record profits, but the money is failing to filter through into pay-packets. No longer protected by import restrictions or indulged by docile Japanese consumers, corporate Japan is feeling the hot breath of global competition on its own doorstep for the first time. Under the circumstances, companies are showing themselves remarkably reluctant to spend on anything other than productivity-boosting plant and equipment.

Thus even as Mr Fukui fears a return of the bubbly 1980s, others fret about a rerun of August 2000, when the BoJ raised rates prematurely, killing off a nascent recovery and deepening Japan's deflation. The economy has enjoyed five years of continuous growth since then—technically the longest boom since the second world war. But it is still haunted by falling prices. Excluding food, Japan's consumer inflation was only 0.1% in the year to December, down from 0.2% in November. And retreating energy costs may yet snuff out even these faint, inflationary embers.

But Mr Fukui's sights are set further ahead. He makes policy according to the inflation outlook about two years down the road. Over that period, Japan's recovering economy will surely begin to press against its supply-side limits, pushing up wages and prices. Shareholders certainly seem optimistic. After the bank's decision, the Topix stockmarket index closed at a 15-year record, hitting heights not seen since Japan's slide into deflation. Perhaps Mr Fukui's forward-looking policy has something to look forward to.

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Buttonwood

Investing for kicks

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The quixotic appeal of exotic assets

NEXT time a defender for your local football club scores an own goal, take a quick look around the ground. The people booing loudest may not be the die-hard fans in the replica shirts but the pension-fund managers who have acquired a share in the player.

Taking a punt on the football transfer market is just one of the ideas being peddled to jaded investors eager for something new. Pension funds, for example, are tired of relying on the stockmarket for capital gains, and wary of the low yields available from corporate bonds and property. By looking further afield, they hope to earn excess returns and narrow their gaping deficits.

In the world of finance no new idea is complete without its Greek letter. In the dim and distant past, picking the best stocks was just seen as being clever; now that skill is known as “alpha”. The letter “beta” is reserved for the boring, old strategy of simply tracking the market. But what if you can find exciting, new markets to track—markets that do not move in step with shares or government bonds? That could be extremely valuable. Hence the phrase “alternative beta”, which refers to non-traditional sources of return, such as taking advantage of changes in market volatility, or exploiting gaps between the spot and futures prices of commodities.

“Exotic beta” represents the wilder fringes of this trend, the equivalent of an art collector buying old comics or baseball cards. Daniel Gore of Orthogonal Partners, a firm that specialises in the area, says the aim is to find managers who are inventive in fields that are not congested by existing investors and in markets that may suffer from mispricing. Uncovering that mispricing may require specialised knowledge that few investors possess, creating profitable barriers to entry.

One of the earliest exotic assets was the catastrophe bond, the provision of back-up capital to insurance companies dealing with earthquakes or hurricanes. But by now, the catastrophic is arguably too familiar to be truly exotic. More recent ideas include managing distressed power stations and buying delinquent credit-card debts from banks. Any of these brainwaves might turn out to be duds. But the hope is that large profits from the few winners will offset the inevitable losers. The approach is akin to that of a venture capitalist spreading his bets among new ideas in fund-management.

The football idea involves providing money to second-tier clubs (not Chelsea or Arsenal) to buy stakes in younger players. The fund then reaps a share of the rewards when the player is sold later in his career (footballers generally become more valuable as they approach their mid-20s). Why should clubs agree to this? Because they are usually short of money and can buy new players only by selling existing ones. By creating shares in their footballers, clubs can realise some of the equity in their human assets, without damaging the prospects of the team.

The very fact that investors are even considering these approaches shows how difficult their life has become. Fifty years ago, safety was the watchword for pension funds, insurance companies and endowments; they bought the bonds of governments and blue-chip companies. Then it was noticed that a diversified portfolio of shares was a lot less risky than most people thought and delivered superior returns over the long term. The cult of the equity was born.

But the bear market of 2000-02 showed how dangerous it was to rely on stockmarkets alone. Now the models for modern investment institutions are the endowments of Harvard and Yale. They long since moved into alternative assets such as hedge funds and private equity, and have reaped handsome returns.

The trouble is that, in aggregate, investors suffer from a version of Tantalus's curse; they may be able to

see attractive returns but they cannot all get hold of them. As more money flows into an investment category, prices rise and the scope for excess returns diminishes. This already seems to have happened with hedge funds and commodities, and it may be about to happen with private equity, given the amount of capital that it has recently raised.

Hence the search for exotic beta. It is all rather reminiscent of the drive into emerging markets in the 1990s, as investors moved from the aristocracy of the asset class—places like Hong Kong and Singapore—into wannabe economies like Indonesia and Ecuador. A series of mishaps followed, as countries lurched into default or devaluation. The future of exotic beta is likely to be similar. Some investors will end up buying the football skills of Victoria, rather than David, Beckham.

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Chinese consumption

Can pigs fly?

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China's households are not as tight-fisted as you think

THE year of the pig, which the Chinese ushered in last weekend, is supposed to bring prosperity. But China has a reputation for holding back, not pigging out. It saves much more than it invests, resulting in a vast current-account surplus, estimated at 8% of GDP last year. This surplus angers America's exporters, who want China to buy more of their goods, rather than salting money away.

People often put the blame on China's tight-fisted consumers, who save too much and spend too little. Official figures appear to confirm their guilt, showing that household consumption has fallen from 46% of GDP in 2000 to only 37% last year.

But many economists reckon China's consumption is much stronger than the official tally suggests. If measured correctly, it may be up to ten percentage points larger as a share of GDP (and investment lower by the same amount).

Other indicators certainly suggest that consumers are having a ball. Car sales have risen by 30% over the past year; sales of mobile phones and household electronics are up by 20-40%. Retail sales as a whole grew by 12.3% in real terms in the year to the fourth quarter, well ahead of GDP growth. Indeed, for the first time in ages, they probably grew faster than investment, according to Jonathan Anderson of UBS, who thinks the government's fixed investment figures are misleading.

Even these robust retail sales understate the strength of consumer spending, says Arthur Kroeber of Dragonomics, a Beijing-based economic research firm. They exclude services, the fastest-growing item in many household budgets. An alternative, quarterly survey of household spending by the National Bureau of Statistics suggests the share of services has doubled since 1995, to one-third of the total.

Both this survey and the retail-sales figures enter into the GDP measure of consumption. But this gauge is the most distorted of the lot. Before the national accounts were overhauled in 2005, China's GDP failed to reflect many unreported services. The recast figures showed a bigger share of services in the economy, but a smaller share of consumption. Mr Anderson finds this odd: surely many of those newly discovered services were consumed by households.

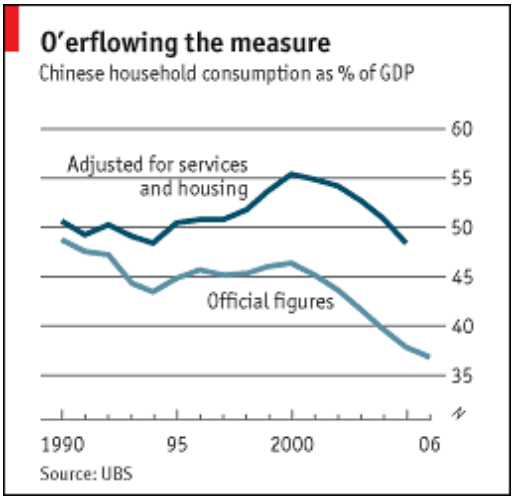
Consumption figures also exclude spending on residential housing. This has surged since the late 1990s, when China's communists first allowed households to buy their homes. Mr Anderson adds investment in homes to the consumption tally, along with much of the extra spending on services discovered in the 2005 GDP revision. He finds consumption's share of the economy today is no lower than its average of the past two decades (see chart).

Thus consumers are not to blame for the extra thrift that has driven China's trade surplus. Companies are. Since 2000 household saving as a share of GDP has barely changed, but companies' gross saving rate has shot up by nearly seven percentage points, because of bumper profits.

That profit surge has, in turn, made consumption look weaker than it really is. As profits have climbed as a share of national income, household wages have fallen, from 53% of GDP in 1998 to 41% in 2005. Thus, as the World Bank points out in its latest *China Quarterly Update*, even if households had spent the same share of their pay-packets, their expenditures would have fallen relative to GDP.

What does this mean for China's critics? America's Treasury is urging its Chinese counterparts, in their Zhongnanhai headquarters, to stoke household spending. But if firms, not consumers, are to blame for China's trade surplus, such policy advice will fail. China still needs to liberalise consumer finance and bolster social-safety nets, but these are slow-burn prescriptions that will not shrink China's trade surplus in the short term.

Something else may. If China's pent-up demand for housing is satisfied in the near future, its consumers will spend their money on other things, including foreign goods. This switch will owe nothing to the government's much-touted measures to boost spending, which are designed to keep its American critics at bay. But, says Mr Kroeber, “like all governments, the denizens of Zhongnanhai will not be shy about taking credit for the shift.”



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Banking

A twist or two of Basel

Feb 22nd 2007 | NEW YORK
From The Economist print edition

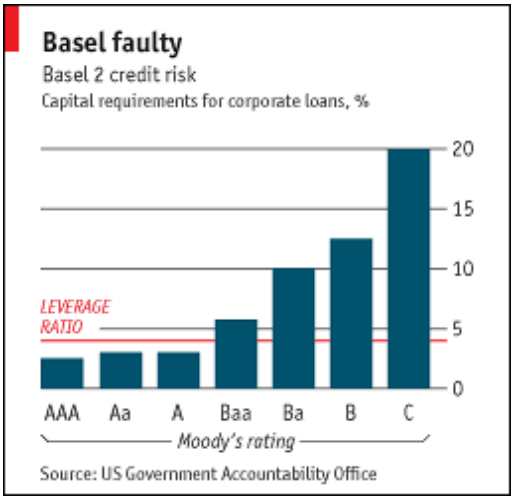
Europe and America cannot agree on new global banking rules

BASEL, a quiet Swiss city bordering both France and Germany, is one of those place-names that people pronounce according to taste. A similar difference of approach is now afflicting the new world banking accord, dubbed Basel 2, which was thrashed out in the city almost three years ago. Since January 1st many European banks have begun implementing the new rules, which govern how much capital they must set aside to cushion themselves from various calamities. The same process was meant to be unfolding in America. But there the banks are struggling to get their mouths around the new accord.

A great deal of money is on the line for banks on both sides of the Atlantic. The more capital they must squirrel away to satisfy regulators, the more insulated they are from untoward events—but the less money remains to be put to work in order to make profits.

Happily for the bottom lines of big European banks, regulatory capital is expected to drop under the new regime—perhaps dramatically. Under Basel 2, the amount of capital a bank must sit on depends on the riskiness of its loans and other assets. So those expert in managing and minimising risk—by packaging loans into securities and selling them on, for example—can get away with a thinner cushion than others. Indeed, big, sophisticated banks will largely make up their own minds about how much capital to set aside, as long as their internal risk-management models are up to snuff. This is meant to reward the banks that already invest in cutting-edge risk-management methods, and prod others to catch up.

Banks in America, on the other hand, are glum. Their regulators have taken fright over studies showing that banks' required capital could fall by an average of 16% if they embraced the new accord. European regulators are inclined to let regulatory capital fall (subject to the discretion of national authorities). American regulators are not. They have now proposed changes in America's version of Basel 2 that will delay its implementation until at least January 2009. Under their proposals American banks will be subject to a number of “safeguards” that keep capital cushions plump. These include the “leverage ratio” (see chart), a blunt measure of a bank's lending exposure that is not linked to the riskiness of its activities.



The accord was intended as a single worldwide standard. But it now threatens to be qualitatively different in Europe and America. International banks that straddle the Atlantic are in a bind and America's large banks are especially irritated. On February 7th four of them, including Citigroup and JPMorgan Chase, wrote a letter of complaint to regulators. These extra restrictions, the banks wrote, give foreign competitors an edge, because they can hold less capital for identical assets.

There may be some truth in this. But America's regulators are too uneasy about the Basel 2 project to lighten up. They think the accord relies too heavily on banks' in-house risk models, which are fallible and “highly subjective”, as one regulator put it. Quietly, some also worry about European banks, which already have much higher levels of leverage than American ones and hold less capital to offset it.

Others fret about a lack of transparency. Under Basel 2, national regulators can force individual banks to boost capital reserves if they see fit. But in Europe it is unclear what an unacceptable level of capital might be, or how bank regulators would react if a bank edged towards it.

There is no such ambiguity in America, where banks have been held to a stringent regime known as “prompt corrective action”. This came into law in 1991 in the wake of America's savings-and-loan debacle, in which more than 2,900 banks failed. Then, regulators repeatedly threw lifelines to struggling banks, which only postponed their inevitable collapse. Now, they have much less scope for leniency. They must take specific, and increasingly severe, actions—from curbing lending to closing a bank—as a bank's capital ratios deteriorate. The idea is to intervene before banks get into trouble, and to make the consequences of falling into the red zone clear to banks and investors well before anything bad happens.

American regulators will not budge on these issues soon. Indeed, Sheila Bair, one of America's bank regulators, thinks that her foreign counterparts should adopt something like the American approach to buttress Basel 2. A number of European bank regulators and academics agree. But politicians in Europe have reservations. They point out, rightly, that America's approach is largely untested, because the country's banks have enjoyed good times since 1991. They also worry that adding the leverage ratio, which disregards risk, to Basel 2 would render all their past work irrelevant.

In fact, each side can learn from the other. The Europeans should add clarity to Basel 2. The Americans should add a bit of urgency to implementing it. No doubt the accord has flaws, but these can be fixed later. In the meantime, it would be better to finalise a rule on Basel 2, however they choose to pronounce it.

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South Africa's economy

How to spend it

Feb 22nd 2007 | JOHANNESBURG
From The Economist print edition

The South African state has a welcome fiscal problem

Reuters

Get article background

WHEN South Africa's apartheid regime conceded power in 1994, it also bequeathed an economic shambles. The government's budget was in the red, interest rates were uncomfortably high, and the country's economy was as distorted as its society. But this fiscal year, for the first time, the government is running a surplus. And Trevor Manuel, its finance minister, who presented his 11th budget this week, is expecting to repeat the trick in the coming year which begins on April 1st.

That is not all he has to boast about. The economy, after a long, fallow period, has grown by more than 4% in each of the past three years. A recent survey by Markinor, a market-research firm, revealed that two-thirds of South Africans think the government is managing the economy well, twice as many as six years ago.

But long-standing problems remain. About half the population falls below the poverty line, according to some estimates. And although the economy creates 500,000 jobs a year, unemployment remains stubbornly high. Is it time for Mr Manuel to loosen the purse strings?

Rudolph Gouws, chief economist at Rand Merchant Bank in Johannesburg, thinks not. South Africans have gone on a spending spree, which has helped demand but hurt saving. As a result, investment, which has risen to 18.4% of GDP, has relied on foreign capital. South Africa's current-account deficit is close to 6% of GDP. Mr Manuel sees his fiscal surplus as the government's contribution to a national saving effort. “We would like our citizens to follow this example,” he says.

But trade unions are critical of the government's self-discipline, arguing that it has done much for business, but little to improve the lot of poor South Africans. With the economy and public finances in good health, the government has grown determined to play a more active role in the economy. The idea of a “developmental state” has gained currency, based on the view that market forces alone cannot reduce entrenched poverty and inequality. Mr Manuel argues that “without a powerful countervailing force, the shadow of history will dictate opportunities, entitlements and outcomes.”

Close to 12m of South Africa's 47m people already receive some government grant or another. The reach of running water, sanitation, roads and electricity has been expanding. A government plan to raise economic growth is under way. It aims to build infrastructure, slash red tape, boost exports, and create more unskilled jobs. Money is also being spent on stadiums and transport, preparing the country to host the 2010 football World Cup. The “parastatal” companies—such as Eskom, which provides power, and

Transnet, which runs ports, pipelines and railways—are also raising money themselves to finance their ambitious investment plans.

All told, the government intends to spend 2 trillion rand ($278 billion) over the next three years—an increase of almost 8% a year. Mr Manuel will also cut taxes a bit. But his boldest move is a plan to create a social-security scheme by 2010.

Even if the government were to throw all caution to the wind, it would struggle to spend faster. The state raises revenues more efficiently than it spends them. Provinces and municipalities, responsible for things like housing, water and sanitation, routinely underspend their capital budgets. Local governments struggle to hire managers and engineers, leaving many essential posts unfilled. The central government is trying to strengthen municipalities, but the pace of change is slow. The developmental state it dreams about is still in the developmental stage.

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Emerging markets

Bye-bye EMBI

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The dollar is losing popularity among emerging-market borrowers

RAFAEL CORREA has brought a fresh face to Ecuador's presidency and some anachronistic habits to its treasury. Last week he quibbled over $135m of interest due on his country's foreign bonds, before coughing up at the last minute. Mr Correa thinks Ecuador's debt is partly “illegitimate” and lacks a whole-hearted commitment to repaying on time and in full.

This kind of inconstancy is, however, quite out of season among Ecuador's neighbours and peers. Emerging-market sovereigns are deemed safer than ever, judging by the prices that investors are willing to pay for their securities. For the past 15 years, the traditional gauge of that risk was the emerging-market bond index (EMBI), compiled by JPMorgan, which has tracked the price of dollar-denominated bonds ever since the international capital markets re-embraced emerging economies in the early 1990s. The global version of this index last month yielded just 1.67 percentage points over riskless American Treasuries, the thinnest spread ever. Mr Correa's shenanigans since then have barely caused a ripple.

Retirement, not delinquency, is a more fashionable fate for emerging-market bonds these days. Many governments have tried to buy back nearly all of their external debt in an effort to impress creditors and reach investment grade. Indeed, the stock of external debt is so low, and spreads so thin, that JPMorgan is losing faith in its own benchmark. Spreads on the global EMBI do not “reflect the dynamics currently at play in emerging markets,” the bank says.

The index's obsolescence reflects the decline in the dollar as the currency of emerging economies' borrowing. Dollar bonds now account for just 28% of their outstanding government debt. Securities issued in a country's own currency—pesos or zlotys, not dollars—are more worthy of investors' attention, JPMorgan says.

This is a welcome shift. After the Asian financial crisis, Barry Eichengreen of the University of California, Berkeley, and Ricardo Hausmann of Harvard University noted that crisis-hit emerging economies all suffered from the same “original sin”: their governments could not borrow in their own currency. No amount of good works could save them. Even governments with sound policies, such as Chile's, shared this problem. As a result, currency crises automatically became debt crises. When the local currency fell, the burden of the country's dollar-denominated debt rose, often to unsustainable levels.

But since then, emerging economies have been undergoing a sort of redemption. Buoyant global commodity prices and healthy manufacturing exports have given them a collective trade surplus. And while the dollar was regarded as a safe haven in the 1990s, pessimism about its future has increased investor demand for currencies considered to be undervalued. As a result, even Argentina, which is still wrangling with jilted bondholders in the courts over its 2001 default, is issuing new debt in pesos and finding ready takers.

But there is more to this transformation than a standard swing of the business cycle. Many countries now float their currencies to some degree, and most have abandoned the boom-time deficit spending that paved the way for subsequent defaults. And even though issuing dollar-denominated bonds is cheaper, numerous finance ministers appear to think the safety of borrowing in one's own currency is worth the cost. It is always reassuring to know you can print the money you owe.

In addition, the more sovereign—and corporate—debt that is issued in local currencies, the deeper and more resilient local capital markets become. Even governments running healthy budget surpluses are issuing new securities, in an effort to add liquidity to their financial systems. Their securities provide a benchmark for corporate bonds, allowing companies to borrow for longer periods. With currencies under better control, markets for derivatives and the securitisation of products like mortgages are also beginning to sprout. Eventually, the middle classes in these nations may enjoy the kind of access to credit that rich-country consumers now take for granted.

But despite the explosive growth projected for these capital markets, it is too early entirely to write off original sin or the EMBI. Analysts still value it, as a snapshot indicator of the risk of investing in these countries. And it might take only one rogue central banker to send lenders scurrying back to the dollar. “The ability to borrow in your own currency is a great convenience,” says Arijit Dutta, who covers emerging markets for Morningstar, an investment-research firm. “In the long term, it will be structural improvements that determine if they retain this privilege.” The redeemed can always relapse.

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Economics focus

Carry on speculating

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How traders have been triumphing over economic theory

NO COMMENT on the financial markets these days is complete without mention of the "carry trade", the borrowing or selling of currencies with low interest rates and the purchase of currencies with high rates. The trade is often blamed for the weakness of the Japanese yen and the unexpected enthusiasm of investors for the New Zealand and Australian dollars.

But why does the carry trade work? In theory, it shouldn't—or not for as long as it has. Foreign-exchange markets operate under a state of "covered interest parity". In other words, the difference between two countries' interest rates is exactly reflected in the gap between the spot, or current, exchange rate and the forward rate. High-interest-rate currencies are at a discount in the forward market; low-rate currencies at a premium.

If that were not so, it would be possible for a Japanese investor to sell yen, buy dollars, invest those dollars at high American interest rates for 12 months and simultaneously sell the dollars forward for yen to lock in a profit in a year's time. The potential for arbitrage means such profits cannot be earned.

However, economic theory also suggests that "uncovered interest parity" should operate. Countries that offer high interest rates should be compensating investors for the risk that their currency will depreciate. In other words, the forward rate should be a good guess of the likely future spot rate.

In the real world, uncovered interest parity has not applied over the past 25 years or so. A recent academic study* has shown that high-rate currencies have tended to appreciate and low-rate currencies to depreciate, the reverse of theory. Carry-trade strategies would have brought substantial profits, not far short of stockmarket returns, although dealing costs would have limited the size of the bets traders could make.

Academics have struggled for some time to explain this discrepancy. One possibility is that investors demand a risk premium, separate from the better interest rate, to compensate them for investing in a foreign currency. As this risk premium varies, it might overwhelm the effects of interest-rate changes. For example, American investors might worry about the credibility of the Bank of Japan, but Japanese investors may regard the dollar as a "safe haven". This would drive the dollar up and the yen down.

However, according to Andrew Scott, of the London Business School, it has been a struggle to find risk premiums that are large enough to explain exchange-rate volatility. So academics have been looking at the structure of foreign-exchange markets, to see if behavioural factors might be at work.

One obvious possibility is that the actions of carry traders are self-fulfilling; when they borrow the yen and buy the dollar, they drive the former down and the latter up. If other investors follow "momentum" strategies—jumping on the bandwagon of existing trends—this would tend to push up currencies with high interest rates.

Financial jaywalking

Such a strategy has its dangers. It has been likened to "picking up nickels in front of steamrollers": you have a long run of small gains but eventually get squashed. In the currency markets, this would mean a steady series of profits from the interest-rate premium that are all wiped out by a large, sudden shift in exchange rates: think of the pound's exit from the European exchange-rate mechanism in 1992. The

foreign-exchange markets have been remarkably calm since the Asian crisis of 1998 (when the yen rose sharply, hitting many carry traders). So a whole generation of investors may have grown up in a state of blissful innocence, unaware that their carry strategy has severe dangers.

Inflation may provide an alternative explanation. The theory of purchasing-power parity (PPP) implies that high-inflation currencies should depreciate, relative to harder monies. In other words, while nominal exchange rates might vary, real rates should be pretty constant. And over the very long term, this seems to happen. A study by the London Business School†, with ABN Amro, a Dutch bank, found that real exchange rates in 17 countries moved by less than an average of 0.2% a year over the period 1900-2006.

Other things being equal (such as roughly similar real interest rates across countries) nominal interest rates should be higher in countries with higher inflation rates. So this should give support to uncovered-interest parity and deter the carry trade. Clearly, though, PPP has not been a useful guide over the past ten years, as the deflation-prone yen has declined against the dollar.

Perhaps the success of the carry trade reflects biases built up in an earlier era, during the inflationary 1970s and 1980s. Currencies prone to inflation back then, such as sterling and the dollar, have had to pay higher interest rates to compensate investors for their reputation. In fact, because inflation has declined, investors in Britain and America have been overcompensated for the risks—a windfall gain that has been exploited by followers of the carry trade. However, it is hard to believe that this effect could have lasted for as long as it has. So the reasons for the success of the carry trade remain a bit of a mystery.

What does seem plain, however, is that the carry trade tends to break down when markets become more turbulent. In such conditions, those who borrowed yen to buy other assets (such as emerging-market shares) might face a double blow as the yen rose while asset prices fell. If the turbulence were sufficiently large, many years' worth of profits from the carry trade might be wiped out. A steamroller could yet restore the reputation of economic theory.

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* "The Returns to Currency Speculation", by Craig Burnside, Martin Eichenbaum, Isaac Kleshchelski and Sergio Rebelo

† Global Investment Returns Yearbook 2007

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The American Association for the Advancement of Science

Making an impact

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The first of five reports from America's annual gathering of scientists looks at the threat of being hit by an asteroid

National Geographic

LATE in 2004 astronomers made an alarming discovery. Initial estimates of the orbit of an asteroid, discovered a few months earlier, suggested that there was a 1% chance of it colliding with Earth in 2029. With further measurements this probability increased to nearly 3%. The asteroid was dubbed Apophis, the Greek name for an Egyptian god of destruction. This seemed fitting, since the asteroid is about 250 metres across, some five times larger than the objects that produced Meteor Crater in Arizona, roughly 50,000 years ago, and the Tunguska event in 1908, which flattened 2,000 square kilometres of Siberian forest. If Apophis did hit Earth, someone would get an extremely nasty headache indeed.

The good news is that, thanks to more precise measurements, the asteroid is no longer deemed a serious threat. It will pass within 32,000 kilometres (20,000 miles) of Earth in 2029. But studying this near miss has concentrated the minds of researchers wonderfully. For, small though the chance of a large asteroid hitting home might be, the consequences would be devastating. Moreover, the danger can be averted for a reasonably small sum, as a panel of experts concluded at this year's meeting of the American Association for the Advancement of Science, held in San Francisco.

America's space agency, NASA, is soon expected to launch a new, much more detailed survey of potentially threatening asteroids. And researchers have come up with new ideas about how to divert any future asteroid that proves to be on a collision course. The bad news is that forecasting asteroid impacts remains a tricky business. An intriguing twist to the Apophis tale shows why.

Know your enemy

During the simulation of the 2029 encounter with Apophis, it became clear that under the right conditions, the asteroid would be deflected into a new orbit that would send it back to threaten Earth exactly seven years later. There is a so-called keyhole—a narrow range of orbits—that would return Apophis in 2036, should it pass through the keyhole in 2029. The keyhole is just 600 metres wide, and forthcoming data are expected to show Apophis will not pass through it, ruling out further possible collisions with the asteroid for the next 100 years.

However, many more of these threatening asteroids will surely be found in coming years (indeed, within the past two months, a newly discovered object 1km across caused a brief flurry, until its orbit was properly calculated). By 2009 NASA will complete a survey meant to pinpoint 90% of all potentially threatening near-Earth objects that are 1km or more in diameter. That survey was requested by America's Congress nearly a decade ago, and was stimulated in part by the dramatic images of Comet Shoemaker-Levy, whose collision with Jupiter in 1994 generated a great deal of public awareness of the risk of asteroid impacts. (A couple of Hollywood films exploring doomsday scenarios also swayed opinion.) In 2005 Congress ordered the survey that is about to start. This is aimed at extending the 90% coverage level by 2020 to smaller nearby objects—all those bigger than 140 metres across. On top of that, NASA's charter has also been changed explicitly to include a responsibility to provide advance warning of potentially damaging asteroid impacts.

The preferred way to deal with rogue asteroids is still a Hollywood-style heroic space mission to knock the object off course, or possibly blow it up—although almost surely as an unmanned effort. However, Edward Lu, of NASA's Johnson Space Centre, has recently proposed an intriguing alternative, which he outlined to the meeting in San Francisco. The idea is to send a satellite to hover alongside a threatening asteroid and, using the gravitational attraction between the two objects, to pull the asteroid gradually off course. Even though the force acting on the asteroid would be extremely small, the cumulative effect over a week or so should be enough to do the trick.

The advantage of such a “gravitational tractor”, as Dr Lu has dubbed it, is that it is more likely to leave the asteroid intact. Many asteroids are weakly bound piles of rubble, held together by their own minute gravitational attraction. An explosive device could scatter debris and greatly increase the probability of a terrestrial collision, albeit a smaller one.

As Steve Chesley of NASA's Jet Propulsion Laboratory pointed out, however, there is a complex trade-off to be made when deciding what to do about an asteroid that may be on a collision course with Earth. The faster a gravitational tractor is dispatched, the smaller and cheaper it need be to achieve its goal. On the other hand, a longer wait means a more accurate gauge of the asteroid's orbit, and thus of the need to do anything at all. Since even a small mission to an asteroid costs hundreds of millions of dollars, this is not an easy choice, especially considering the growing number of potential collisions that a more detailed survey will probably uncover.

Nor is it clear who should make the choice. Rusty Schweickart, a member of the Association of Space Explorers, a club of ex-astronauts and cosmonauts, has been working with his colleagues to lobby the United Nations to put asteroid-impact planning on the agenda. However, given the glacial pace at which the organisation moves, this may not provide a good enough emergency response.

Another thing worrying Mr Schweickart is that NASA has no plans to test an asteroid-deflection scheme. However, the European Space Agency does have such a project in the pipeline. With an irony the organisers have not, perhaps, properly appreciated, it is known as Don Quijote. The mission will have two craft, Hidalgo and Sancho. As in Cervantes's novel, the servant will observe while his master makes a fool of himself by crashing blithely into the target asteroid. If all such asteroids turn out to be harmless windmills, it will have been a wasted effort. But if one does, indeed, turn out to be a threatening giant, future generations may be very glad of the Don's headlong charge.

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Smart prosthetics

Bionic people

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We can rebuild him. We have the technology

ABLE-BODIED readers, imagining themselves crippled by a broken spine, might not necessarily think of urinary incontinence as being at the top of the list of their problems. Ask those who are actually crippled, though, and it is, indeed, top for all those who do not need mechanical help to breathe. Designing electronic bladder-control devices is therefore not the minor sideline that might naively be thought. And that is exactly what William de Groat of the University of Pittsburgh does.

Dr de Groat was one of a group of speakers at this week's meeting of the American Association for the Advancement of Science who described recent advances in what they refer to as smart prosthetics—and the rest of the world, in thrall to a 1970s television series called “The Six Million Dollar Man”, refers to as bionics. What these researchers are actually engaged in, though, is the construction of parallel nervous systems that fill in what injury or disease has destroyed.

A healthy individual's bladder is regulated by his brain. One set of nerves keeps it relaxed while another keeps tight the sphincter through which it empties. When stretch receptors in the bladder's wall tell the brain it is full, the system goes into reverse. (How much control an individual has over this depends on the signal from the stretch receptors.)

If the spinal cord is damaged in a way that cuts the bladder off from the brain, the nervous tissue below the break will often remodel itself to create a new bladder-emptying reflex. But it does not do a very good job. The bladder neither fills nor empties properly. Dr de Groat's device overcomes this by stimulating one particular nerve that is connected to the sphincter. Studies in animals have shown that signals from this nerve can control the new bladder reflex. Low-frequency electrical stimulation prompts urine storage. High-frequency stimulation prompts emptying. Although the device will not restore voluntary voiding, and patients will not know when they are going to urinate, the bladder will empty more completely and far less frequently than without the prosthesis. This not only reduces incontinence, but also the risk of bladder infection.

Having solved the problem of urination, however, most of those paralysed by spinal-cord injury would like to be able to move again. Hunter Peckham of Case Western Reserve University in Cleveland, Ohio, and John Donoghue of Brown University in Rhode Island are trying to help them to do just that.

Dr Peckham's parallel nervous system picks up electrical signals from the neck and shoulder muscles. These muscles have some involvement in normal arm and leg movement, as the body's whole posture changes when the limbs move. When they twitch useful information about the brain's intentions can be extracted from them.

A cable that runs under the skin from the neck electrodes to the patient's abdomen carries information to a small box that transmits it to another box, which is worn over the skin and contains a computer processor. The two boxes form the alternative nervous system's alternative brain. A program written by Dr Peckham's colleagues interprets the signal and decides which arm or leg muscles need to contract, and by how much, in order to accomplish what the brain is trying to achieve. Each of the relevant muscles has been wired up to the internal box (which is powered by electrical induction from a battery in the external one). The information on how much to contract is translated into pulses of electricity that are sent to each of the relevant muscles and bingo! a previously paralysed patient is able to pick things up, stand or even walk—albeit with the assistance of a Zimmer frame.

Dr Donoghue's system goes even further. He has been experimenting with the idea of collecting signals straight from the brain's motor cortex and using them to direct mechanical devices such as artificial arms and even wheelchairs. After extensive trials on monkeys, he has now studied four human patients who

each have had an array of 100 tiny electrodes implanted in their brains. These people are able to manipulate objects using mechanical arms and hands.

The next step would be to link the two ideas together and have Dr Donoghue's brain electrodes direct Dr Peckham's boxes. That really would act like an artificial nervous system bypassing the patient's broken natural one. And it shouldn't cost $6m a man.

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Obesity

Enter the obesogen

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Exposure in the womb to certain chemicals may lead to obesity

“IS THE environment making us fat?” That is the intriguing question posed by Bruce Blumberg of the University of California, Irvine. His research into endocrine disrupters—chemical compounds that interfere with the body's normal processing of hormones such as oestrogen—has led him to conclude that some of them may well encourage obesity.

The notion of such “obesogens”, as Dr Blumberg calls them, is controversial. Some insist that diet and exercise (or, rather, the lack thereof) are the simpler explanations for obesity, with perhaps a dash of genetic predisposition thrown in. However, a panel of experts convened at the American Association for the Advancement of Science meeting argued that those factors are insufficient to explain the dramatic increase in obesity seen across the world since 1980. Caloric intake and exercise levels have not altered enough to explain the difference, the scientists maintained, and human genes cannot have changed in such a short time.

Some environmental-health experts suspect that fetal exposure to nasties found in everyday plastics might be the underlying explanation of the recent obesity trend. John Peterson Meyers of Environmental Health Sciences, an advocacy group, observes that a number of synthetic chemicals widely found in the environment have been shown to alter the activity of genes, even when they are present at extremely low concentrations. This disruptive effect has not been fully appreciated, he argues, because safety trials on these substances have concentrated on the risks posed by high concentrations rather than low ones.

Research on animals seems to bolster this hypothesis. Retha Newbold of the National Institute of Environmental Health Sciences, a government agency in America, points to diethylstilbestrol (DES) as an example. This drug, the first orally absorbable synthetic oestrogen, was given to pregnant women in the 1950s to help them avoid miscarriage. The drug fell out of favour when it transpired that children exposed to it ended up with damaged reproductive organs. Ms Newbold has now discovered that early DES exposure also leads to obesity in adult mice. As her experiments controlled for both diet and exercise, she thinks fetal exposure to the drug must play a role in the fattening that was evident later in life. How this happens is unclear, but she speculates that the compound may interfere with the body's ability to deal with glucose in the blood.

Other synthetic hormones and endocrine disrupters common in the modern world seem to have a similar impact, and not just in the womb. A study of Japanese women has suggested a link between obesity and adult exposure to bisphenol-A, a component of plastic bottles. Frederick vom Saal of the University of Missouri has investigated the impact of early exposure to this compound. His work on laboratory animals showed that fetal exposure to bisphenol-A led to obesity and cancer. Dr vom Saal says that new research should be done to clarify the role of “perinatal programming of obesity”.

Plastics are not the only potential culprits. Dr Blumberg has identified tributyl tin, which is found not only in PVC plastics but also in fungicides. Tributyl tin is part of a larger group of chemicals known as organo-tins, which combine tin and hydrocarbons; the link with obesity was discovered only relatively recently. Dr Blumberg believes the compound interferes with the body's normal fat-formation process, and puts its fat-storage mechanism on overdrive, plumping up the person.

Dr Meyers claims this amounts to “a revolution unfolding in environmental-health sciences”. Perhaps. It is possible that the long-marginalised scientists of the environmental-health field are right, and that these endocrine disrupters do play a part in explaining the ongoing trends in obesity. However, as the more cautious of them admit, that cannot be verified until the animal experiments are scaled up to proper, long-term human studies which can verify their hypothesis. Until then, it is probably best to go easy on the pizza—and work out at the gym.

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Political science

Election forensics

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How to detect voting fiddles

A WEEK is a long time in politics. And a decade is a long time in political science. Ten years ago, bright young academics would probably have thought that analysing the impact of ballot formats and comparing the merits of voting machines was unworthy of intellectual pursuit. The 2000 presidential election in America, with its butterfly ballots and controversial outcome, changed all that and spurred a more scientific approach to studying voting and how it might be subverted.

One way to detect fraud is to use statistics. Walter Mebane and his team at Cornell University have devised a new method of doing so, which they described to the American Association for the Advancement of Science. It is similar to that of a mathematical curiosity known as Benford's law. This law states that in certain long lists of numbers, such as tables of logarithms or the lengths of rivers, the first digit of each number is unevenly distributed between one and nine. Instead, there are far more numbers beginning with one—about a third of the total—and far fewer starting with nine. For example, a 2km stream is twice as long as a 1km stream; by contrast, a 10km stream is only 11% longer than a 9km stream. So you will find more streams measuring between 1km and 2km than between 9km and 10km.

The pattern that Dr Mebane has detected concerns not the first but the second digit of lists of election results from different precincts of a constituency, where he also observes a non-uniform distribution of possible digits. The effect is far more subtle, with zero occurring about 12% of the time and nine turning up on 9% of occasions. Dr Mebane has observed this pattern with great consistency for voting results from precincts across the United States in recent elections. The cases where there are significant deviations from the pattern correlate well with places where there have been known problems of election rigging.

In contrast with more sophisticated statistical analyses, which require laborious research to correlate voting patterns with variables such as race, wealth or historical precedent, Dr Mebane's test can be applied to data without further ado. It is a very simple test for fraud.

Dr Mebane is careful to point out that the test is not foolproof. It sometimes fails to detect a discrepancy in a vote that is known to have been problematic, and occasionally detects fiddling where there was none. However, he has managed to develop a mathematical model that explains the distribution of the second digits, putting what might appear to be a statistical oddity on a more solid footing. He has also had some encouraging success using it in practice.

One example concerns an analysis of the last three elections in Bangladesh. The 1991 election showed no strange results. For the 1996 election some 2% of results were problematic. And fully 9% of the results in 2001 failed the test. The 2001 election was fiercely contested. Yet monitors from the Carter Centre and the European Union found the election to be acceptably, if not entirely, free and fair. Tests like Dr Mebane's one could provide monitors with quantitative estimates of exactly how free and fair an election has been, on which to base their qualitative judgment of whether that is indeed acceptable.

As Jasjeet Sekhon of the University of California, Berkeley, points out, the emerging field of election forensics presents opportunities as well as risks. In the best cases, it is encouraging political scientists to team up in an interdisciplinary way with statisticians, economists, psychologists and even software engineers, to understand the complex interplay between human and technological factors that can influence an election. These collaborations force political scientists to question some of their cherished assumptions in the light of insights that experts from other disciplines bring to the problem.

On the downside, the excitement surrounding this sort of research can attract self-appointed experts with a limited knowledge of the realities of voting. For example, statistical discrepancies between exit polls and

actual votes cast have been used by some to deduce widespread fraud on statistical grounds. In fact, it has long been known that exit polls, though they may claim to be based on random samples, suffer from biases in the way that they are conducted. In America these tend to skew the results towards the Democrats.

Dr Sekhon notes that, thanks to Karl Rove, the mastermind of George Bush's election victories in 2000 and 2004, the Republicans have been far more effective at exploiting new scientific information about voting and elections. Indeed, several of his colleagues have been surprised to receive hand-written notes from Mr Rove pointing out minor blemishes in their academic articles. “In contrast, the Democrats have had faith-based electioneering tactics,” says Dr Sekhon. The party often engages in activities such as contacting people who have voted in the primaries, which can be shown to be a waste of time and money. In 2008 its workers would do well to consult the latest scientific literature instead.

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Medical statistics

Signs of the times

Feb 22nd 2007 | SAN FRANCISCO
From The Economist print edition

Why so much medical research is rot

PEOPLE born under the astrological sign of Leo are 15% more likely to be admitted to hospital with gastric bleeding than those born under the other 11 signs. Sagittarians are 38% more likely than others to land up there because of a broken arm. Those are the conclusions that many medical researchers would be forced to make from a set of data presented to the American Association for the Advancement of Science by Peter Austin of the Institute for Clinical Evaluative Sciences in Toronto. At least, they would be forced to draw them if they applied the lax statistical methods of their own work to the records of hospital admissions in Ontario, Canada, used by Dr Austin.

Dr Austin, of course, does not draw those conclusions. His point was to shock medical researchers into using better statistics, because the ones they routinely employ today run the risk of identifying relationships when, in fact, there are none. He also wanted to explain why so many health claims that look important when they are first made are not substantiated in later studies.

The confusion arises because each result is tested separately to see how likely, in statistical terms, it was to have happened by chance. If that likelihood is below a certain threshold, typically 5%, then the convention is that an effect is “real”. And that is fine if only one hypothesis is being tested. But if, say, 20 are being tested at the same time, then on average one of them will be accepted as provisionally true, even though it is not.

In his own study, Dr Austin tested 24 hypotheses, two for each astrological sign. He was looking for instances in which a certain sign “caused” an increased risk of a particular ailment. The hypotheses about Leos' intestines and Sagittarians' arms were less than 5% likely to have come about by chance, satisfying the usual standards of proof of a relationship. However, when he modified his statistical methods to take into account the fact that he was testing 24 hypotheses, not one, the boundary of significance dropped dramatically. At that point, none of the astrological associations remained.

Unfortunately, many researchers looking for risk factors for diseases are not aware that they need to modify their statistics when they test multiple hypotheses. The consequence of that mistake, as John Ioannidis of the University of Ioannina School of Medicine, in Greece, explained to the meeting, is that a lot of observational health studies—those that go trawling through databases, rather than relying on controlled experiments—cannot be reproduced by other researchers. Previous work by Dr Ioannidis, on six highly cited observational studies, showed that conclusions from five of them were later refuted. In the new work he presented to the meeting, he looked systematically at the causes of bias in such research and confirmed that the results of observational studies are likely to be completely correct only 20% of the time. If such a study tests many hypotheses, the likelihood its conclusions are correct may drop as low as one in 1,000—and studies that appear to find larger effects are likely, in fact, simply to have more bias.

So, the next time a newspaper headline declares that something is bad for you, read the small print. If the scientists used the wrong statistical method, you may do just as well believing your horoscope.

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About sponsorship

Africa and the CIA

Waiting for the plutocrats' friend

Feb 22nd 2007
From The Economist print edition

Corbis

Larry Devlin was America's man in Africa. Nearly half a century after he arrived in Kinshasa, the fabled former Congo station chief tells his side of the story

Get article background

IF ONE man personified the cold war in Africa—that ruinous contest between the greatest powers in the world's weakest states—it was Larry Devlin. Smart, ambitious and hard as bullets, a second-world-war veteran who equated communists with Nazis, he was one of the CIA's first station chiefs in Congo, where he arrived just days after it was made independent by Belgium in 1960—at two weeks' notice.

There was chaos there already. Soldiers lynched their Belgian officers and hunted for white women to rape. The newly elected government, led by Patrice Lumumba, a former postal worker and petty crook, was paralysed and clueless. Because of mutineers at the airport Mr Devlin reached Kinshasa, Congo's riverside capital, in a small boat from nearby Congo-Brazzaville: a classic voyage of modern Africa, since taken by countless spooks, fugitive politicians, rebel invaders, diamond smugglers, mercenaries and journalists, during Congo's many meltdowns.

Chief of Station, Congo: Fighting the Cold War in a Hot Zone
By Larry Devlin

PublicAffairs; 304 pages; $26 and £15.99

Buy it at
Amazon.com
Amazon.co.uk

Mr Devlin and his masters have been blamed for much of Congo's awful history, which culminated, between 1996 and 2002, in two wars that claimed several million lives. And there is good reason to blame them; to keep the Russians out of Africa, they did dreadful deeds.

Lumumba took help from the Soviet Union, having been influenced by Ghana's Kwame Nkrumah, the father of Africa's independence leaders, and by Belgium's efforts to split the new Congo and control its richest part. So Mr Devlin plotted with the country's army chief, Joseph Désiré Mobutu, a recently promoted sergeant, to have the prime minister arrested. When Lumumba continued to cause problems and Congo collapsed into civil war, President Dwight Eisenhower personally ordered his assassination, according to Mr Devlin. A CIA agent, a chemist codenamed “Joe from Paris”, turned up in Kinshasa with poisons, including one concealed in a tube of toothpaste, with which Mr Devlin was to perform this act. He never did. Lumumba was kidnapped, tortured and murdered in 1961, by his Congolese rivals and their Belgian allies, probably with America's acquiescence. He remains an important symbol to Africans,

and socialists everywhere, of resistance to Western imperialism.

As Congo's crisis continued, Mr Devlin encouraged Mobutu (pictured above) to launch a coup in 1965. In his defence—the main purpose of this memoir, which he has written after enduring decades of abuse for his professional misdeeds—Mr Devlin says he was not directly involved in the coup. Maybe not; though Mobutu consulted him before and after it, and allowed him to help pick his first cabinet.

America was delighted with its new ally against communism: Mobutu Sese Seko Kuku Ngbendu Wa Za Banga ("the all-powerful warrior who goes from conquest to conquest, leaving fire in his wake"), as Sergeant Joseph renamed himself. He also renamed Congo as Zaire, and ruled it as his personal fief for 32 years. He was popular at first, uniting the country and righting the economy. He made Zaireans proud to have such a leader. But by the mid-1970s Zaire had become a kleptocracy, consuming massive Western aid and its own assets. During two stints as Congo station chief, Mr Devlin did much to help create this nightmare, conniving with Mobutu and his allies, confounding their enemies. In 1974, after quitting the agency, he returned to Congo to work for Maurice Tempelsman, an enigmatic diamond dealer and companion, in her final years, to Jacqueline Onassis.

Mr Devlin's was an unsavoury career. But so was that of any successful cold-war spy. His adventures, which he tells quite well, included dodging cannibal mutineers and murderous Western mercenaries; surviving numerous mock executions; and driving around Kinshasa with a rigid corpse sticking out of his trunk. Had it not been for the Church Committee, which was formed by the Senate in 1975 to investigate CIA abuses, including its involvement in Lumumba's killing, Mr Devlin would always have been considered a hero; he was decorated for valour for his spying during the Vietnam war.

It is wrong to demonise the old warrior. But cold-war politics helped create the calamity that is Congo, and much of Africa, today. It will fall to less partial historians than Mr Devlin to decide whether the risk of Africa falling to communism justified the terrible cost the continent has paid.

Chief of Station, Congo: Fighting the Cold War in a Hot Zone.
By Larry Devlin.
PublicAffairs; 304 pages; $26 and £15.99

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Europe

Approaching a 50th birthday

Feb 22nd 2007
From The Economist print edition

Photographer's Choice

Birthday blues

In Europe: Travels through the Twentieth Century
By Geert Mak

Harvill Secker; 876 pages; £25. To be published in America by Pantheon in August

Buy it at
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LATE next month Europe's political leaders will meet in Berlin to mark the 50th anniversary of the Treaty of Rome. Today's European Union sprang directly from that treaty. An economic club that began with six members has grown into a far-reaching political entity that has 27 members, 500m inhabitants and constitutes the world's biggest economic and trading block.

Reaching 50 ought to be a joyous occasion. Yet no celebration in Berlin can hide the fact that the EU is in something of a mid-life crisis. For most of the past decade its economic growth has been feeble and its unemployment unacceptably high. Nobody knows where to draw its boundaries. And since France and the Netherlands voted “no” in two referendums in 2005 it has been unable to agree on its own constitution. Enthusiasts hope that the Berlin reunion will lead to a revival of that plan. They are deluding themselves.

A flood of books, articles and broadcasts is expected to mark the 50th birthday. This is not, in fact, such a book. A Dutch journalist and historian, Geert Mak, spent the last year of the 20th century travelling around the continent for his newspaper, *NRC Handelsblad*. His musings were gathered into a book that became a bestseller in the Netherlands in 2004. Now the publishers have had the bright idea of bringing out an English translation just before the Rome treaty anniversary.

Mr Mak does indeed tell of the origins of the EU, notably by drawing on the words and wisdom of Max Kohnstamm, a Dutchman who worked closely with Jean Monnet, the project's French founding father. But his book is really a broader travelling history of the whole of Europe's 20th century. As befits a journalist with an eye for bad news, he also has much more to say on its calamitous first half than on its more successful second half.

Mr Mak's travels start in the capitals that glittered so brightly in the early 1900s: Paris, Berlin, Vienna, St Petersburg, London. This was a time when Europe seemed unchallenged in its prosperity and leadership. But much of this was thrown away in the mud, filth and death of what the author calls the war of 1914-45. Mr Mak tells this part of his story vividly and in great, gory detail, moving from grim fields of battle (Verdun, Stalingrad) to stirring places of revolution (Petrograd, Berlin), and on to ghastly charnel-houses of death and destruction (Auschwitz, Dresden).

Through the book runs one powerful common strand: nationalism and the end of Europe's multi-ethnic

way of life. Mr Mak finds a telling quote from Hitler, who declared that “the essence of Europe is not geographical but racial.” The first world war did for the continent's three great multinational empires: the Habsburg, the Russian and the Ottoman. The cataclysmic 1939-45 war destroyed much of what was left, killing along the way as many as 40m people in Europe, including 6m Jews.

Mr Mak rightly plays up the centrality of the two world wars to Europe's 20th century. As he notes, it is not possible to appreciate the forces that play out in eastern Europe or the Balkans, say, without a comprehensive understanding of these regions' experience in the second world war, and the cold war that followed. This is also why he devotes less space to Britain and France than to places farther east.

It is equally impossible to grasp the origins of the European Union without dwelling on the two wars. The founders wanted above all to avoid repeating the experience of the first half of the century. Monnet and his fellows were convinced that nationalism lay at the root of Europe's troubles. Their answer was to lay the foundation stones for a supranational state.

Yet the tension between nationalism and supranationalism was there from the start. Charles de Gaulle, with his fierce attachment to France, was in some ways the first Eurosceptic. He was also deeply suspicious of British intentions towards the European project, because Winston Churchill once told him that he would always choose the open sea over Europe.

Euroscepticism has increased over the past decade, and is now found even in the 12 countries that have joined the EU since Mr Mak first wrote his book. Yet as he explains in an epilogue added in 2006, the problems of the EU run deeper than just coping with Euroscepticism. Young Europeans do not fret over the risk of another war, so that part of Monnet's dream means nothing to them. Instead they see a remote, bureaucratic and in some ways undemocratic organisation—and not one that offers them a dream at all. No constitution will change that, something the leaders who will be gathering in Berlin would do well to realise.

In Europe: Travels through the Twentieth Century.
By Geert Mak.
Harvill Secker; 876 pages; £25. To be published in America by Pantheon in August

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About sponsorship

The Panama Canal

A path between the seas

Feb 22nd 2007
From The Economist print edition

ON FEBRUARY 1st 1881 Ferdinand de Lesseps, the French diplomat who built the Suez Canal, read to a waiting group of French journalists a telegram containing two words: "*Travail commencé.*"

The news that work had begun on de Lesseps's second canal project seemed at the time to herald the final round of a challenge that had fascinated a long line of men from Christopher Columbus to Benjamin Franklin: to excavate a ship canal across the narrow waist of South America. The waterway would significantly cut the journey time between New York and San Francisco and offer a shorter passage to the East. Such was the excitement generated by de Lesseps's project, and not only in France, that in no time a literary wag had turned it into a palindrome: A MAN, A PLAN, A CANAL—PANAMA is still one of the longest palindromic phrases in the English language.

Excitement in France was one thing. But the reality in Panama was quite another. Few engineering projects in history have been launched with so much arrogance and so little preparation.

Panama Fever: The Battle to Build the Canal
By Matthew Parker

Hutchinson; 464 pages; £20

Buy it at Amazon.co.uk

Fresh from constructing a sea-level canal through the flat Egyptian sand, de Lesseps was determined, without having set foot in Panama and after only the vaguest of topographical studies, that his project through the mountainous central American isthmus would also be a sea-level canal, requiring no locks to cope with changes in altitude. The heat, humidity, insects, snakes and diseases were, said the director of the engineering company contracted to do the work, "nothing but an invention of the canal's adversaries".

The plan had the backing of the French government, but it was financed mostly through public subscription, the personal savings of thousands of ordinary French people who regarded de Lesseps as a hero on a Napoleonic scale.

In less than a decade, however, the scheme had collapsed. De Lesseps's insistence that the canal be built without locks had led engineers to try to cut directly through the rock to sea level. Yet in less than 30 miles (48km) between Colón and Panama City there are six major geological faults, five significant volcanic cores and 17 different kinds of rock. It is not the easiest place to build. By 1889, eight years after work began, only a third of the canal had been excavated. So extensive were the wet-season mudslides that in some years more mud and rock fell back into the canal than had been taken out in the first place.

More than 5,000 French people died, many of them graduates of the country's most prestigious engineering schools. Thousands more Indian and Caribbean workers too succumbed to the malaria and yellow fever that swept the isthmus during the rainy season. In all, over 25,000 people died, 500 for each mile of the canal. De Lesseps was ruined, his son imprisoned for fraud. The French government that backed the scheme had collapsed.

It would take another quarter century, a campaign of American intervention ordered by President Theodore Roosevelt, the creation of a fenced canal zone and nearly a decade of work by the US Army Corp of Engineers before the Panama Canal was officially opened in 1914; comparable in scale and ambition to the building of the pyramids of Egypt. Although much shorter than the canal at Suez, it required three times the excavation and ended up costing four times as much.

The tale of the French and American efforts to build the Panama Canal has been told before, particularly well by David McCullough in his 1977 epic, “The Path Between the Seas”. Using a bottom-up approach to his research, as opposed to Mr McCullough's top-down method of looking at the project through a geopolitical prism, Mr Parker has written the Panama story for a new generation. He quotes extensively from letters and diaries of ordinary workers writing home to their families. And it is their heartfelt views on the conditions in which they lived and worked that really bring this book to life.

“Death was our constant companion,” wrote one West Indian worker, Alfred Dottin. “I shall never forget the trainloads of dead men being carted away daily, as if they were just so much lumber...There were days that we could only work a few hours because of the high fever racking our bodies—it was a living hell.” As the Panamanian government prepares to widen the canal for the first time in nearly a century, this is a history with lessons for the future.

Panama Fever: The Battle to Build the Canal.
By Matthew Parker.
Hutchinson; 464 pages; £20

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New fiction

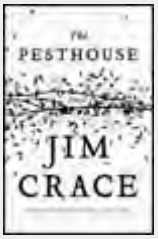
Go east

Feb 22nd 2007
From The Economist print edition

THE uncanny resemblance between Cormac McCarthy's recent novel, “The Road”, and Jim Crace's new book, “The Pesthouse”, does not mean Mr Crace is an imitator. He would have finished his manuscript by the time “The Road” came out. Yet within less than a year, two established American novelists have drawn harrowing portraits of a post-apocalyptic America, across which their characters trudge in desperation to find a safer, healthier haven. Between Iraq, terrorism and global warming, America has tunnelled to a dark place, where (at least for novelists) the future holds more horror than promise.

Mr Crace's road novel is vivid on its technologically regressive condition, although sketchy on the details of what went wrong. In a diseased, lawless, polluted wasteland, the whole remaining American population is on the move from west to east, where, it is said, ships await to cart the remnants of a once-great nation to the Valhalla of other lands. A rare survivor of the deadly “flux”, Margaret teams up with Franklin, a decent, gangling emigrant from a western state, and heads for the Atlantic. Perils beset the travellers: slavers, rapists and thieves. In one witty section, Margaret finds refuge with a religious cult that eschews metal—even belt buckles—from which all evil hails.

The Pesthouse
By Jim Crace



To be published in America by Nan A. Talese in May
Picador; 309 pages; £16.99.

Buy it at
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With only horse or barrow for transport, their exodus recalls a western in reverse—an eastern, perhaps. Once Europeans piled onto ships and sailed hopefully to America. Now Americans are the tired and poor, the struggling masses yearning to be free—begging their way onto similar vessels, pining for the opposite shore.

Mr McCarthy's language may be the more striking, but Mr Crace has his own distinctively rolling, rhythmic style: “This used to be America, this river-crossing in the ten-month stretch of land, this sea-to-sea.” Besides, there's no need to choose between the two. Take these twins on holiday, and another choice presents itself: whether to celebrate the present or get really depressed instead.

The Pesthouse.
By Jim Crace.
Picador; 309 pages; £16.99.
To be published in America by Nan A. Talese in May

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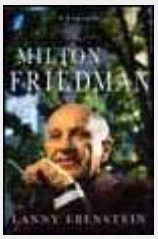
Milton Friedman

Too faithful a portrait

Feb 22nd 2007
From The Economist print edition

THE best word to describe Lanny Ebenstein's life of Milton Friedman, finished just days before he died in November, is economical. Its subject would no doubt count this a virtue. He was a man who stopped grading student exam papers after the first 1,000 words; who lived tidily within his means even during the Great Depression; and who once boiled down his capitalist vision to just three words: free private property.

Milton Friedman: A Biography
By Lanny Ebenstein



Palgrave Macmillan; 272 pages; $27.95 and £16.99

Buy it at
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Readers might have hoped for a bit more fat with their lean. John Kenneth Galbraith's biographer, Richard Parker, served up 800 pages, full of spit and crackle; Robert Skidelsky needed three volumes to take the measure of John Maynard Keynes. By those standards, Mr Ebenstein's biography lacks ambition and heft. But it is quite handy. It marshals lots of material, and to devotees the bibliographical essay at the end may be worth the cover price in itself.

Mr Ebenstein is not wholly to blame for this book's modesty. Unlike Galbraith, who reserved a good part of his genius for his life, Friedman's personal transactions add little dash or drama to his story. He liked woodwork. He met his wife, Rose, in an economics class. The book's only moment of romantic tension arrives when she refuses his kiss at the end of their first date. If Galbraith enters his biography like a character in a Graham Greene novel, Friedman is introduced in the language of a school report: “In addition to his intellect, he has a strong work ethic, an engaging personality, and an excellent sense of humour.” Mr Ebenstein too, it seems, likes working with wood.

The first third of the book gives an absorbing account of the making of an economist. Friedman's scholarship adhered to the carpenters' maxim: “measure twice, cut once”. Blessed with a quick mind, capable of the deepest of incisions, Friedman also had the patience for meticulous statistical labour. During the war he crunched numbers for his country, calculating the optimum number of pellets in anti-aircraft shells.

These twin virtues are apparent in the middle third of this life, which lightly glosses over Friedman's most celebrated insights, such as his refutation of the bleak notion that capitalism is doomed to underconsumption, and his reassessment of the Great Depression. Here too Mr Ebenstein's quandary becomes clear: Friedman was an open book, a fine expositor of his ideas and his life. This makes his biographer's job easier, but also less necessary.

Mr Ebenstein's footnotes contain almost 100 references to the memoir, “Two Lucky People”, that Friedman and his wife published in 1998. “What I say to one person, I say to everyone,” he told Mr Ebenstein in their first interview. The last third of this book, which should have been a fascinating account of his role as a public intellectual, instead recounts Friedman saying much the same thing to everyone, from American presidents to Chinese communists.

Given that Friedman has left his admirers nothing to expose, and little need to expound, what is there left for a biographer to do? Argue with him. This book tells of exhilarating debates, stretching late into the night, but it does not take part in one. The biographer does not share his subject's taste for playing devil's advocate.

This is a pity. Friedman has now been laid to rest, but his ideas have not. Should Catholic adoption agencies be allowed to turn away gay couples—a debate now raging in Britain? Friedman would have had a view. Many people now back his proposal for school vouchers, as a way to get the most out of state

schools. But Friedman was keen to get the state out of schooling altogether. No one seems to like big government any more, but Friedman wanted a state so small it would cost less than 15% of national income. Even in his 80s, this book reports, he would occasionally hop onto his grandson's skateboard. It is easy to think that he never learned how to stop.

Of one of his early Chicago mentors, the great economist once wrote: “He taught us that an objective, critical examination of a man's ideas is a truer tribute than slavish repetition of his formulas.” This biography will do for now. But Friedman still awaits a truer tribute.

Milton Friedman: A Biography.
By Lanny Ebenstein.
Palgrave Macmillan; 272 pages; $27.95 and £16.99

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About sponsorship

New theatre

Prince of our disorder

Feb 22nd 2007
From The Economist print edition

A “Hamlet” for the brave

WHEN it came to thinking through how to stage her new, avant-garde version of “Hamlet”, one thing that the director, Elizabeth LeCompte, knew was that it should not look a bit like the Danish castle where Shakespeare's most famous play takes place. So the stage is cluttered with microphones, monitors and cables. A video-screen serves as a backdrop. The set looks far more like a recording studio than Elsinore.

Looking on his like again

An actor comes to the front, taps a microphone and asks if the audience is ready. This is Scott Shepherd, who plays the prince. Perhaps the audience is about to witness a rehearsal, or a “Hamlet” made up on the spot, or another play altogether. With Ms LeCompte's Wooster Group you never know. That is the point. They dismantle illusion before any attempt has been made to mount one.

Since 1975, when a small group of like-minded writers and actors got together in a New York space known as the Performing Garage on SoHo's Wooster Street to improvise with new texts and some old ones, nothing in a theatre is sacred when the Woosters are in residence. The acting is stylised, often deliberately mechanical and monotonous. And they make extensive use of video and amplification. Plays, such as Racine's “Phèdre” or Chekhov's “Three Sisters”, are deconstructed and re-assembled with new motifs.

In “Brace Up!”, the Woosters' Chekhov, there was a strong Japanese flavour. In “To You, the Birdie!” (“Phèdre”), the action was reconstructed around a badminton game, shuttlecocks landing on the ground to the sound of shattered crockery.

There is a trick, too, behind their “Hamlet”. Scenes from a modern-dress Broadway production, starring Richard Burton as the prince and filmed over two nights in 1964, flicker on the screen throughout the two-and-a-half-hour performance. The actors on stage—seven in all, covering all parts (Kate Valk plays both Hamlet's mother Gertrude and Ophelia)—take a stance, then reposition themselves as the film stops and restarts. Their words sometimes echo those in the film or occasionally anticipate them. Sometimes there is no film at all and, unusually for this group, an intact original text unfolds with gripping, though brittle, intensity.

Ms LeCompte explains that it was Mr Shepherd's obsession with the play, which he knows by heart, that encouraged her to try it. She was especially impressed when one day she saw him and Ms Valk

improvising the great scene in Act III between the prince and his mother: “I had kind of ignored the play, so I listened to audio-tapes, some going back 100 years. The Burton production I saw live and that actually changed theatre in New York. This was Shakespeare giving in to celebrity, and it totally freshened him up.”

This “Hamlet” will appal some for being so resolutely unclassical. But the play is all there. Probably only the Wooster Group would dare inflict such technological terrorism on it, yet leave its audience with so entertaining a revelation.

The Wooster Group's “Hamlet” is at St Ann's Warehouse, Brooklyn, New York, from February 27th to March 25th

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Maurice Papon

Feb 22nd 2007
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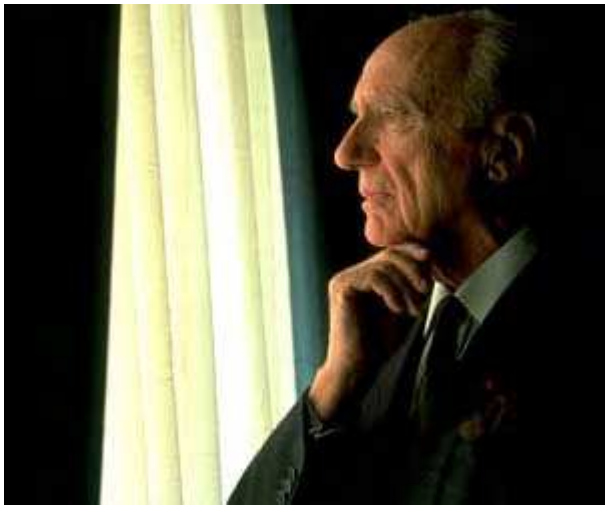
Maurice Papon, collaborator, died on February 17th, aged 96

Corbis



AMONG the ranks of the French civil service, it would be hard to find a more perfect example than Maurice Papon. Well informed, elegant yet self-effacing, he had the confidence of a man who had passed with smooth diligence through some of the best *lycées* in Paris. In his prefectures, with the tricolour furled behind his desk, instructions were carried out to the letter and correct form was followed. *Un fonctionnaire*, as the tag went, *est fait pour fonctionner*: the purpose of a bureaucrat is simply to do his job.

The Germans who occupied Bordeaux found Mr Papon easy to work with. The secretary-general of the prefecture of the Gironde, as he became in 1942, proved courteous and pleasant, an admirable officer of the Vichy regime that had been set up, in ostensible neutrality, to govern France alongside the Nazis. Occasionally, on delicate issues, he would hide behind his boss, the prefect; but in general he was dependable and “correct”. He could be relied on not merely to do what Vichy and Berlin asked, but even to go further.

And he was a busy man, in charge of traffic, petrol rationing, requisitions and Jewish questions. These were two: status (identity, parentage, whether baptised) and Aryanisation (transfer of their property to non-Jews). Mr Papon had to arrange the seizure of Jewish shops, lands and jewellery across the whole region, their valuation and their sale by auction. In July 1942, in a first report, he noted that he had “dejudaised” 204 businesses, while 493 others were “in the process of dejudaisation”.

That summer he also received other orders. He was to round up a “sufficient number” of Jews and send them to a staging camp at Drancy, in northern France. And he was to make such convoys regular. This meant ordering arrests, arranging police escorts and organising express trains that would not stop at stations. He managed it with his usual competence. Between 1942 and 1944 1,690 Jews were shipped out of Bordeaux, including 223 children. Most ended up in Auschwitz.

Had he known they would? No, he insisted later, nor did he have any inkling of the Nazis' broader plans. He had certain fears about Drancy. But people had to understand that he was not a free agent. There was a German *imperium* in force; Vichy was subject to it and he, after 1940, obedient to Vichy. With the coming of the Nazis numbers of civil servants had been sidelined or silenced, but he had a job to do, and “desertion was not in his ideology”. There was a duty to survive, to keep things running, to avoid gratuitous provocation that might make a bad case worse. In Bordeaux he resisted in his own way, he said: taking names off arrest-lists, tipping off families in advance, sheltering a rabbi in his house. Why,

he even chartered the city trams to spare the very young or old the walk to the station, and booked passenger trains, not goods wagons, to make their journey comfortable.

A code of silence

These self-justifications came out at Mr Papon's trial, one of only two of French officials who collaborated with the Nazis in their crimes against humanity. Hundreds more might have been charged, including all those who worked for him. But once the Vichy leaders had been executed for treason after the Liberation, a different imperative prevailed: to keep France united, to avoid recriminations and to draw a veil over the past. In this new version of history all Frenchmen had resisted, including those who were now intent on quietly protecting each other. In his mind Mr Papon, too, had spent the Occupation fighting.

For almost four decades after the war he continued his steady upwards climb. He was prefect in Corsica, in Morocco and in Algeria; after 1958 he assumed charge of the Paris police, under orders from de Gaulle to “hold the city” against rioting Algerian nationalists. Those orders, as usual, were carried out with maximum efficiency; in one operation in 1961 up to 200 Algerians were killed, their bodies for days afterwards dragged out of the Seine. He had done his duty, Mr Papon said later. He had kept order. The Légion d'honneur was conferred on him, joining his treasured medal of the Resistance.

By 1981, now deputy for Cher, he had reached the cabinet as budget minister. Punctiliously, he was going after the rich who were evading taxes. But at the same time the families of the Jews he had deported were going after him. Lists and reports, carefully filed away, were discovered in corners of the town hall in Bordeaux. An article in *Le Canard Enchaîné*, a satirical weekly, forced his resignation from government; 16 years of languid inquiries and technical hitches followed. His eventual trial, in 1997-98, was the longest in French history. It ended with a sentence of ten years in prison, of which he served three until ill health excused him.

In court, assured as ever, he played the scapegoat. He felt no remorse, had no regrets. He had done his job. Most days, a walking affront to the self-delusion of France, he would appear with his yellow dossier underneath his arm. He would lay the papers out neatly before him, making constant notes. At one point, when a psychiatrist was called, he objected. He was not insane. Though perhaps, he added bitterly, he was mad to have stayed so long in the service of the state.

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Overview

Feb 22nd 2007
From The Economist print edition

The **Bank of Japan** raised its key interest rate by a quarter of a percentage point, to 0.5%. In its statement, the bank acknowledged that inflation might fall to “around zero” in the near term, but argued that a rate rise was warranted to guard against “excess financial and economic activities.”

Consumer prices in **America** rose by 0.2% in January. Excluding food and energy, prices rose by 0.3% in January after three consecutive monthly increases of 0.1%. The number of private-housing starts fell by 14.3% in January and by 37.8% from a year earlier.

The **euro area's** current-account surplus widened to €2.3 billion ($3 billion) in December, from €0.9 billion in November. For 2006 as a whole, the current account was in deficit to the tune of €16.2 billion, or 0.2% of GDP.

In **France** GDP rose by 0.6% in the fourth quarter, below the euro-area average, according to preliminary estimates. In 2006 as a whole, GDP rose by 2.0%. French consumer prices rose by 1.2% in the year to January, down from 1.5% in the year to December.

In **South Africa** consumer prices rose by 6.0% in the year to January, above December's rate of 5.8%. Excluding interest on mortgage bonds, prices rose by 5.3% in the year to January, leaving inflation within the central bank's 3-6% target range.

Germany's growth of 3.7% in the year to the fourth quarter was mainly owing to strong exports, which grew by 6% in the fourth quarter compared with the third.

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Output, prices and jobs

Feb 22nd 2007
From The Economist print edition

Output, prices and jobs

% change on year ago

	Gross domestic product				Industrial production	Consumer prices			Unemployment
	latest	qtr*	2006†	2007†	latest	latest	year ago	2007†	rate‡, %
United States	+3.4 Q4	+3.5	+3.4	+2.6	+2.6 Jan	+2.1 Jan	+4.0	+1.9	4.6 Jan
Japan	+2.1 Q4	+4.8	+2.1	+1.9	+4.8 Dec	+0.3 Dec	–0.4	+0.4	4.1 Dec
China	+10.4 Q4	na	+10.5	+9.4	+14.9 Nov	+2.2 Jan	+1.9	+2.5	9.8 2006
Britain	+3.0 Q4	+3.2	+2.7	+2.5	+0.5 Dec	+2.7 Jan**	+1.9	+2.2	5.5 Dec††
Canada	+2.5 Q3	+1.7	+2.8	+2.3	–2.2 Nov	+1.2 Jan	+2.8	+1.7	6.2 Jan
Euro area	+3.3 Q4	+3.6	+2.7	+2.0	+4.0 Dec	+1.9 Jan	+2.4	+2.0	7.5 Dec
Austria	+3.3 Q4	+3.3	+3.1	+2.5	+5.6 Nov	+1.5 Dec	+1.6	+1.7	4.6 Jan
Belgium	+3.1 Q3	+2.5	+2.7	+2.1	+3.5 Dec	+1.7 Jan	+2.6	+1.9	11.8 Jan‡‡
France	+2.2 Q4	+2.6	+2.0	+2.0	+0.7 Dec	+1.2 Jan	+2.0	+1.4	8.6 Dec
Germany	+3.7 Q4	+3.5	+2.6	+1.7	+5.5 Dec	+1.6 Jan	+2.1	+2.1	9.5 Jan
Greece	+4.4 Q4	na	+4.1§	+3.5§	+3.1 Dec	+2.7 Jan	+3.2	+2.8§	8.3 Q3
Italy	+2.9 Q4	+4.6	+1.8	+1.3	+5.0 Dec	+1.7 Jan	+2.2	+1.9	6.8 Q3
Netherlands	+2.7 Q4	+2.6	+2.8	+2.5	+5.6 Dec	+1.4 Jan	+1.3	+1.8	5.0 Jan††
Spain	+4.0 Q4	+4.8	+3.7	+3.0	nil Dec	+2.4 Jan	+4.2	+2.6	8.5 Dec
Czech Republic	+5.8 Q3	+5.6	+6.0	+4.8	+3.0 Dec	+1.3 Jan	+2.9	+3.3	7.9 Jan
Denmark	+3.2 Q3	+2.9	+3.5	+2.4	+0.6 Dec	+1.8 Jan	+2.1	+1.9	3.9 Dec
Hungary	+3.2 Q4	+3.2	+3.7	+2.4	+14.0 Dec	+7.8 Jan	+2.7	+6.0	7.5 Dec††
Norway	+2.6 Q3	+5.2	+2.5§	+2.5§	–2.0 Dec	+1.2 Jan	+1.8	+2.6§	2.9 Dec††
Poland	+5.8 Q3	na	+5.3	+4.7	+15.6 Jan	+1.7 Jan	+0.7	+2.5	14.9 Dec‡‡
Russia	+6.5 Q3	na	+6.7	+6.5	+8.4 Jan	+8.0 Jan	+10.6	+8.8	7.1 Jan‡‡
Sweden	+4.4 Q3	+4.1	+4.6	+3.5	+10.3 Dec	+1.9 Jan	+0.6	+1.8	5.3 Jan‡‡
Switzerland	+2.4 Q3	+1.5	+2.7	+2.0	+8.2 Q3	+0.1 Jan	+1.3	+0.9	3.3 Jan‡‡
Turkey	+3.4 Q3	na	+5.2	+4.0	+2.5 Dec	+9.9 Jan	+7.9	+8.6	9.1 Q3‡‡
Australia	+2.2 Q3	+1.2	+2.5	+2.8	+0.9 Q3	+3.3 Q4	+2.8	+2.9	4.5 Jan
Hong Kong	+6.8 Q3	+14.8	+6.0	+5.0	–0.6 Q3	+2.0 Jan	+1.9	+2.5	4.4 Jan††
India	+9.2 Q3	na	+8.3	+7.4	+11.1 Dec	+6.9 Dec	+5.6	+6.2	7.6 2006
Indonesia	+6.1 Q4	na	+5.3	+5.8	+24.2 Nov	+6.3 Jan	+17.0	+6.9	10.3 2005
Malaysia	+5.9 Q3	na	+5.5	+5.2	+6.3 Dec	+3.1 Dec	+3.5	+3.3	3.1 Q3
Pakistan	+6.6 2006§§	na	+6.2§	+6.6§	+6.8 Sep	+6.6 Jan	+8.8	+6.8§	na
Singapore	+6.6 Q4	+7.9	+7.7	+5.0	+5.1 Dec	+0.8 Dec	+1.3	+1.0	2.6 Q4
South Korea	+4.0 Q4	+3.4	+4.9	+4.2	+2.3 Dec	+1.7 Jan	+2.2	+2.8	3.3 Jan
Taiwan	+4.0 Q4	na	+4.1	+3.9	–1.7 Dec	+0.4 Jan	+2.7	+1.5	3.9 Dec
Thailand	+4.7 Q3	+6.0	+4.3	+4.3	+7.0 Dec	+3.0 Jan	+5.9	+3.6	1.2 Nov
Argentina	+8.7 Q3	+10.8	+7.9	+6.3	+2.2 Jan	+9.7 Jan	+12.1	+9.8	10.2 Q3‡‡
Brazil	+3.2 Q3	+1.4	+3.0	+3.3	+2.8 Dec	+3.0 Jan	+5.7	+3.6	8.4 Dec‡‡
Chile	+2.9 Q3	–0.2	+4.7	+5.3	+1.2 Dec	+2.8 Jan	+4.1	+2.5	6.0 Dec††††
Colombia	+7.7 Q3	+8.1	+5.1	+4.5	+17.1 Nov	+4.7 Jan	+4.6	+4.1	11.0 Nov‡‡
Mexico	+4.3 Q4	+1.9	+4.4	+3.2	+1.6 Dec	+4.0 Jan	+3.9	+3.8	4.0 Jan‡‡
Venezuela	+10.2 Q3	na	+7.8	+5.5	+12.2 Sep	+18.4 Jan	+13.1	+20.2	10.1 Q3‡‡
Egypt	+7.1 Q3	na	+5.5	+5.4	+4.0 2005	+12.4 Jan	+3.4	+8.9	10.9 Q2‡‡
Israel	+4.6 Q3	–1.1	+4.2	+4.2	+10.5 Dec	+0.1 Jan	+2.7	+1.7	8.3 Q3
Saudi Arabia	+5.3 2006§	na	+4.2§	+4.1§	na	+2.8 Nov	+1.1	+2.5§	na
South Africa	+4.5 Q3	+4.7	+4.3	+4.2	+5.0 Dec	+6.0 Jan	+4.0	+5.2	25.6 Mar‡‡
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*									
Estonia	+11.6 Q3	+11.7	+11.5§	+9.2§	+5.7 Dec	+5.1 Jan	+4.7	+4.3§	4.3 Dec
Finland	+5.8 Q3	+3.6	+5.2§	+2.7§	+5.8 Dec	+2.3 Jan	+0.8	+1.9§	7.0 Jan
Iceland	+0.3 Q3	+0.4	+2.1§	+0.4§	na	+7.4 Feb	+4.1	+4.9§	1.2 Dec‡‡
Ireland	+7.7 Q3	+10.8	+6.2§	+5.3§	+17.0 Dec	+4.9 Dec	+2.5	+3.4§	4.5 Jan
Latvia	+11.9 Q4	na	+11.6§	+9.2§	+3.2 Dec	+7.1 Jan	+7.5	+6.0§	6.1 Dec
Lithuania	+6.6 Q4	+6.6	+7.3§	+6.5§	na	+4.0 Jan	+3.5	+1.8§	5.7 Dec
Luxembourg	+5.4 Q3	+4.1	+6.0§	+4.6§	+4.5 Nov	+2.3 Jan	+2.9	+3.0§	4.8 Dec‡‡
New Zealand	+1.3 Q3	+1.0	+1.7§	+2.6§	–1.4 Q3	+2.6 Q4	+3.1	+3.0§	3.7 Q4
Peru	+9.0 Dec	na	+6.0	+5.4	+3.0 Nov	+0.6 Jan	+1.9	+1.6	7.5 Dec‡‡
Philippines	+6.5 Q4	+5.6	+5.5	+5.3	–15.4 Nov	+3.9 Jan	+6.7	+4.4	8.0 Q3‡‡
Portugal	+1.5 Q3	–0.6	+1.2§	+1.4§	+3.2 Dec	+2.6 Jan	+2.7	+2.4	8.2 Q4‡‡
Slovakia	+9.5 Q4	na	+7.5§	+6.3§	+8.9 Dec	+3.0 Jan	+4.1	+2.8	12.0 Dec
Slovenia	+5.6 Q3	na	+5.1§	+4.0§	+4.2 Dec	+2.7 Jan	+2.4	+2.3	8.6 Dec‡‡

*% change on previous quarter, annual rate. †The Economist poll. ‡National definitions. §Economist Intelligence Unit estimate/forecast. **RPI inflation rate 4.2% in Jan. ††Latest three months. ‡‡Not seasonally adjusted. §§Year ending June.

Sources: National statistics offices and central banks; Thomson Datastream; Reuters; Centre for Monitoring Indian Economy; OECD; ECB

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The Economist commodity-price index

Feb 22nd 2007
From The Economist print edition

The Economist commodity-price index

2000=100

	Feb 13th	Feb 20th*	% change on one month	% change on one year
Dollar index				
All items	185.1	188.4	+0.8	+21.2
Food	157.8	159.8	+1.5	+15.8
Industrials				
All	220.5	225.3	+0.1	+26.6
Nfa†	155.2	155.2	+1.5	+4.0
Metals	256.2	263.6	–0.3	+36.1
Sterling index				
All items	144.5	146.0	+2.3	+7.9
Euro index				
All items	131.6	132.4	–0.2	+9.6
Gold				
$ per oz	664.15	657.28	+1.8	+18.5
West Texas Intermediate				
$ per barrel	58.94	58.25	+8.5	–4.2

*Provisional †Non-food agriculturals.

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Gold

Feb 22nd 2007
From The Economist print edition

Sales of gold for jewellery reached a new high of $44 billion last year, helping total demand climb to $65 billion, also a record. However, the volume of jewellery demand slipped by 16%, to 2,267 tonnes. According to the World Gold Council, volatile prices hurt jewellery sales in the first eight months of the year. However, sales surged in September and October when prices settled below $600 an ounce—in time for Diwali and Eid al-Fitr. Demand also got a boost in December, when prices fell again, just before Christmas and Eid al-Adha. Purchases of gold for industrial purposes also set new records, in terms of both value and volume, thanks to increased demand from electronics firms.

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Trade, exchange rates, budget balances and interest rates

Feb 22nd 2007
From The Economist print edition

Trade, exchange rates, budget balances and interest rates

	Trade balance* latest 12 months, $bn	Current-account balance latest 12 months, $bn	Current-account balance % of GDP 2007†	Currency units, per $ Feb 21st	Currency units, per $ year ago	Budget balance % of GDP 2007‡	Interest rates, % 3-month latest	Interest rates, % 10-year gov't bonds, latest
United States	−836.1 Dec	−880.3 Q3	−6.1	–	–	−2.2	5.17	4.70
Japan	+81.0 Dec	+170.4 Dec	+3.8	121	119	−4.9	0.45	1.69
China	+183.5 Jan	+160.8 2005	+7.0	7.74	8.05	−1.6	3.60	3.10
Britain	−155.3 Dec	−69.7 Q3	−2.8	0.51	0.57	−2.7	5.52	4.88
Canada	+47.2 Dec	+28.9 Q3	+1.1	1.16	1.15	0.8	4.19	4.12
Euro area	−9.4 Dec	−20.2 Dec	−0.1	0.76	0.84	−1.5	3.84	na
Austria	−1.1 Nov	+12.2 Q3	+1.4	0.76	0.84	−1.1	3.84	4.04
Belgium	+16.5 Dec	+6.8 Sep	+2.0	0.76	0.84	0.1	3.89	4.06
France	−36.6 Dec	−31.8 Dec	−1.1	0.76	0.84	−2.6	3.84	4.05
Germany	+206.0 Dec	+129.4 Dec	+4.1	0.76	0.84	−1.4	3.84	4.00
Greece	−43.4 Nov	−29.6 Dec	−7.1‡	0.76	0.84	−2.9	3.84	4.25
Italy	−26.2 Dec	−42.1 Dec	−1.7	0.76	0.84	−3.2	3.84	4.23
Netherlands	+41.4 Dec	+59.7 Q4	+7.6	0.76	0.84	0.6	3.84	4.03
Spain	−112.7 Dec	−110.7 Nov	−8.5	0.76	0.84	0.3	3.84	4.05
Czech Republic	+2.0 Dec	−5.2 Q3	−3.2	21.5	24.0	−4.2	2.58	3.72
Denmark	+6.7 Dec	+6.7 Dec	+2.7	5.68	6.28	3.5	3.62	4.00
Hungary	−2.7 Dec	−6.9 Q3	−5.2	192	213	−7.1	8.15	7.00
Norway	+56.0 Jan	+56.0 Q3	+17.5‡	6.13	6.79	19.3	4.22	4.52
Poland	−5.1 Dec	−7.1 Dec	−2.3	2.96	3.19	−2.6	4.19	5.20
Russia	+140.8 Dec	+95.6 Q4	+6.2	26.2	28.2	6.0	10.50	6.23
Sweden	+20.7 Dec	+26.2 Q3	+6.3	7.08	7.89	2.9	3.13	3.84
Switzerland	+9.7 Jan	+105.9 Q3	+14.0	1.24	1.31	1.2	2.21	2.58
Turkey	−51.9 Dec	−31.9 Dec	−7.0	1.39	1.33	−2.4	18.80	19.12
Australia	−9.5 Dec	−39.5 Q3	−5.0	1.27	1.36	1.3	6.37	5.79
Hong Kong	−17.9 Dec	+19.2 Q3	+9.8	7.81	7.76	2.0	4.21	4.15
India	−51.7 Dec	−13.7 Q3	−2.7	44.2	44.6	−4.3	8.08	8.13
Indonesia	+39.8 Dec	+7.0 Q3	+1.2	9,069	9,355	−0.9	9.04	6.25§
Malaysia	+29.5 Dec	+22.2 Q3	+11.3	3.49	3.72	−4.3	3.68	5.22§
Pakistan	−13.1 Jan	−6.0 Q3	−5.4‡	60.7	60.0	−4.6	10.29	6.70§
Singapore	+34.4 Jan	+36.3 Q4	+24.5	1.53	1.63	0.3	3.38	3.16
South Korea	+16.4 Jan	+6.1 Dec	+0.1	938	975	1.1	4.95	4.90
Taiwan	+10.9 Jan	+26.3 Q3	+5.6	33.0	32.6	−2.2	nil	2.05
Thailand	+2.2 Dec	+3.2 Dec	+1.3	33.9	39.5	−1.2	4.97	4.59
Argentina	+12.0 Jan	+6.7 Q3	+2.3	3.10	3.07	1.0	9.50	na
Brazil	+45.8 Jan	+13.5 Dec	+0.7	2.08	2.15	−2.2	12.94	6.16§
Chile	+23.9 Jan	+5.2 Q3	+1.0	540	519	4.3	4.92	5.23§
Colombia	nil Nov	−2.3 Q3	−2.0	2,219	2,253	−1.5	6.94	6.16§
Mexico	−5.8 Dec	−1.3 Q3	−0.5	11.0	10.5	−0.4	7.03	7.69
Venezuela	+36.8 Q3	+29.7 Q3	+10.1	3,644	2,677	−3.8	10.08	6.55§
Egypt	−11.7 Q3	+3.0 Q3	+1.4	5.71	5.74	−8.0	8.47	5.35§
Israel	−7.3 Jan	+6.7 Q3	+2.6	4.19	4.72	−2.8	4.54	4.92
Saudi Arabia	+165.7 2006	+90.0 2005	+17.3‡	3.75	3.75	12.3	5.22	na
South Africa	−9.8 Dec	−13.5 Q3	−5.3	7.13	6.10	−2.0	9.30	7.54
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*							
Estonia	−3.3 Nov	−2.3 Dec	−12.7‡	11.9	13.2	1.3	3.92	na
Finland	+12.1 Dec	+12.6 Dec	+5.6‡	0.76	0.84	2.3	3.81	4.07
Iceland	−1.9 Dec	−3.9 Q3	−16.2‡	66.7	67.4	2.1	15.13	na
Ireland	+35.3 Nov	−6.5 Q3	−4.2‡	0.76	0.84	0.8	3.84	4.05
Latvia	−5.0 Dec	−4.3 Dec	−19.5‡	0.54	0.59	−1.2	7.57	na
Lithuania	−5.2 Dec	−3.4 Dec	−10.3‡	2.63	2.91	−0.5	3.88	na
Luxembourg	−5.5 Nov	+4.8 Q3	na	0.76	0.84	−0.8	3.84	na
New Zealand	−4.0 Dec	+6.1 Q3	−9.1‡	1.42	1.52	3.5	6.75	5.92
Peru	+8.9 Dec	+1.8 Q3	+1.0	3.19	3.28	0.1	4.50	na
Philippines	−4.4 Nov	+4.4 Sep	+3.8	48.1	51.9	−0.5	5.00	na
Portugal	−23.2 Nov	−16.9 Nov	−7.8‡	0.76	0.84	−3.7	3.84	4.17
Slovakia	−3.1 Dec	−5.4 Oct	−6.2‡	26.2	31.4	−3.0	4.56	4.31
Slovenia	−2.0 Dec	−1.1 Nov	−1.6‡	0.76	0.84	−1.2	na	na

*Merchandise trade only. †The Economist poll. ‡Economist Intelligence Unit forecast. §Dollar-denominated bonds.

Sources: National statistics offices and central banks; Thomson Datastream; Reuters; JPMorgan; Bank Leumi le-Israel; Centre for Monitoring Indian Economy; Danske Bank; Hong Kong Monetary Authority; Standard Bank Group; UBS; Westpac.

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About sponsorship

Markets

Feb 22nd 2007
From The Economist print edition

Markets

	Index Feb 21st	% change on one week	% change on Dec 30th 2005 in local currency	% change on Dec 30th 2005 in $ terms
United States (DJIA)	12,738.4	nil	+18.9	+18.9
United States (S&P 500)	1,457.6	+0.2	+16.8	+16.8
United States (NAScomp)	2,518.4	+1.2	+14.2	+14.2
Japan (Nikkei 225)	17,913.2	+0.9	+11.2	+8.5
Japan (Topix)	1,787.2	+1.2	+8.3	+5.7
China (SSEA)	3,148.8	+3.2	+157.9	+168.8
China (SSEB, $ terms)	187.6	+1.8	+190.2	+202.5
Britain (FTSE 100)	6,357.1	–1.0	+13.1	+28.7
Canada (S&P TSX)	13,330.3	+1.0	+18.3	+19.0
Euro area (FTSE Euro 100)	1,326.0	–0.4	+21.8	+35.5
Euro area (DJ STOXX 50)	4,232.5	–0.8	+18.3	+31.6
Austria (ATX)	4,533.9	–1.0	+23.6	+37.6
Belgium (Bel 20)	4,515.4	–0.7	+27.2	+41.6
France (CAC 40)	5,694.6	–0.5	+20.8	+34.4
Germany (DAX)*	6,941.7	–0.3	+28.4	+42.9
Greece (Athex Comp)	4,707.0	+0.2	+28.5	+43.0
Italy (S&P/MIB)	42,303.0	–1.4	+18.5	+31.9
Netherlands (AEX)	508.8	+0.1	+16.5	+29.7
Spain (Madrid SE)	1,647.0	–0.7	+42.4	+58.6
Czech Republic (PX)	1,672.2	–2.1	+13.5	+29.9
Denmark (OMXCB)	454.4	–1.5	+23.5	+37.6
Hungary (BUX)	24,039.0	–0.5	+15.7	+28.9
Norway (OSEAX)	517.8	–3.0	+37.4	+51.8
Poland (WIG)	54,821.4	+1.2	+54.0	+69.4
Russia (RTS, $ terms)	1,905.5	+0.8	+54.4	+69.3
Sweden (Aff.Gen)	384.3	–0.1	+31.0	+47.1
Switzerland (SMI)	9,207.1	–1.0	+21.4	+29.2
Turkey (ISE)	42,888.6	–0.9	+7.8	+5.0
Australia (All Ord.)	5,933.3	–0.1	+26.0	+36.1
Hong Kong (Hang Seng)	20,651.4	+2.2	+38.8	+37.8
India (BSE)	14,188.5	+1.3	+51.0	+53.8
Indonesia (JSX)	1,816.6	+3.7	+56.2	+69.5
Malaysia (KLSE)	1,278.2	+2.6	+42.1	+53.7
Pakistan (KSE)	11,521.5	+0.6	+20.6	+18.8
Singapore (STI)	3,293.6	+3.5	+40.3	+52.1
South Korea (KOSPI)	1,451.4	+1.1	+5.2	+13.3
Taiwan (TWI)	7,809.5	nil	+19.3	+18.7
Thailand (SET)	692.4	–0.8	–3.0	+17.3
Argentina (MERV)	2,203.2	+3.4	+42.8	+39.2
Brazil (BVSP)	46,090.0	+0.2	+37.8	+54.5
Chile (IGPA)	13,311.5	–4.7	+44.6	+37.2
Colombia (IGBC)	10,666.1	–2.1	+12.1	+15.6
Mexico (IPC)	28,716.0	+0.6	+61.3	+56.0
Venezuela (IBC)	49,077.8	–0.8	+140.6	+70.8
Egypt (Hermes)	64,459.9	+3.1	+16.4	+17.1
Israel (TA-100)	993.3	–0.8	+20.0	+32.0
Saudi Arabia (Tadawul)	8,245.1	+4.6	–50.7	–50.7
South Africa (JSE AS)	26,306.3	nil	+45.4	+29.3
Europe (FTSEurofirst 300)	1,534.7	–0.9	+20.3	+33.9
World, dev'd (MSCI)	1,534.4	nil	+22.0	+22.0
Emerging markets (MSCI)	937.6	+1.0	+32.7	+32.7
World, all (MSCI)	380.2	+0.1	+22.8	+22.8
World bonds (Citigroup)	655.1	+0.2	+5.6	+5.6
EMBI+ (JPMorgan)	412.7	+0.4	+12.0	+12.0
Hedge funds (HFRX)	1,313.1	+0.3	+12.5	+12.5
Volatility, US (VIX)	10.2	10.2	12.1	(levels)
CDSs, Eur (iTRAXX)†	20.0	–3.3	–45.6	–39.4
CDSs, N Am (CDX)†	26.0	–2.8	–43.6	–43.6
Carbon trading (EU ETS) €	0.85	–22.7	–96.0	–95.5

*Total return index. †Credit-default swap spreads, basis points.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; JPMorgan Chase; Bank Leumi le-Israel; CBOE; CME; Danske Bank; EEX; HKMA; Merrill Lynch; Standard Bank

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Exchange-rate forecasts

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Exchange-rate forecasts

Currency units per dollar

	Feb 21st	3-month	12-month
Euro area*	1.31	1.34	1.32
Japan	121	125	117
Australia	1.27	1.27	1.32
Britain†	1.95	2.01	1.95
Canada	1.16	1.15	1.19
Denmark	5.68	5.58	5.67
Sweden	7.09	6.90	6.89
Switzerland	1.24	1.19	1.19
China	7.74	7.47	6.64
Singapore	1.53	1.51	1.54
South Korea	939	956	989
Brazil	2.08	2.19	2.34
Mexico	11.0	11.1	11.2
Poland	2.96	2.78	2.73
Russia	26.2	25.9	25.2
South Africa	7.11	6.93	7.94

Source: JPMorgan Chase *$ per € †$ per £

Rich-country exchange rates are set for a year of stability, but some developing-country currencies are ripe for revaluation, according to JPMorgan Chase. The bank's currency team expects the Chinese yuan to gain 17% against the dollar in the next 12 months. The Polish zloty is also set for a big rise. Other currencies look vulnerable, though. The South African rand is forecast to be 10% lower in a year's time and the outlook for the Brazilian real is similarly bleak. Of the world's leading currencies, the Japanese yen might lose a little more ground in the next quarter, but revive later. The Swiss franc is set to make and hold a small advance, whereas the pound and the euro should be little changed a year from now.

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